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DESCRIPTION AND ANALYSIS OF PRESENT-LAW TAX RULES RELATING TO INCOME EARNED BY U.S. BUSINESSES FROM FOREIGN OPERATIONS

SCHEDULED FOR A PUBLIC HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON JULY 21, 1995

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on July 21, 1995, on the tax rules relating to income earned by U.S. businesses from foreign operations, including the deferral of U.S. tax on earnings overseas, the tax treatment of passive foreign investment companies, the application of the excess passive assets provision of section 956A of the Code, and the tax treatment of foreign sales corporations.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax rules and a discussion of related issues. Part I of the pamphlet is a description of present-law tax rules. Part II is an analysis of issues relating to international investment. Part III is a comparison of the taxation of foreign income in the United Kingdom, Germany, and Japan. Part IV is a brief discussion of revenue estimating methodology.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Present-Law Tax Rules Relating to Income Earned by U.S. Businesses From Foreign Operations* (JCS–20–95), July 20, 1995.

I. PRESENT LAW

A. U.S. Taxation of Income Earned Through Foreign Corporations

1. Overview

The United States exerts jurisdiction to tax all income, whether derived in the United States or elsewhere, of U.S. citizens, residents, and corporations. By contrast, the United States taxes nonresident aliens and foreign corporations only on income with a sufficient nexus to the United States.[2] In the case of income earned by a U.S.-owned foreign corporation, generally no U.S. tax is imposed until that income is distributed to the U.S. shareholders as a dividend. However, in the case of certain foreign corporations with U.S. shareholders, various anti-deferral regimes contained in the Internal Revenue Code (the "Code") operate to tax U.S. shareholders currently on certain earnings of the foreign corporation (or to impose an interest charge on the U.S. shareholder when income is realized at the shareholder level).

Generally, the United States cedes primary right to tax income derived from sources outside the United States to foreign governments. Thus, the Code provides a credit against the U.S. income tax imposed on foreign source taxable income to the extent of foreign taxes paid on that income. To implement properly the rules for computing the foreign tax credit (and for other purposes), the statute and regulations set forth an extensive set of rules to determine the source, either U.S. or foreign, of items of income, and to allocate and apportion items of expense against those categories of income.

The tax rules of foreign countries that apply to inbound investments vary widely. For example, some foreign countries impose income tax on inbound investment at higher effective rates than are imposed by the United States on the outbound foreign investment. In such cases, the allowance of a foreign tax credit by the United States is likely to eliminate any U.S. tax on income from operations in such a country. On the other hand, operations in countries with low statutory tax rates or rules that permit generous deductions, or in countries that provide tax incentives (e.g., tax holidays) to foreign investors are apt to be taxed at effective tax rates lower than U.S. rates. In such cases, the United States generally will tax a portion of the foreign earnings at some point unless, for example, the taxpayer is permitted to use excess foreign tax credits from operations in high-tax countries to offset the U.S. tax on the income from operations in the low-tax country.

Under income tax treaties, the tax that would otherwise be imposed under applicable foreign law on certain foreign source income earned by U.S. persons may be reduced or eliminated. Moreover, U.S. tax on foreign source income may be reduced or eliminated by a treaty's provision that certain foreign taxes will be considered creditable for purposes of computing U.S. tax liability.

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[2] For a discussion of the U.S. tax rules affecting investment in the United States by foreign persons, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

Other special rules which may affect an outbound investment of a U.S. taxpayer are provided in the Code. For example, the Code and regulations set forth rules for determining transfer prices with respect to related party transactions in order to assure those transactions are conducted at arm's length. Rules are provided to guide the measurement in U.S. dollars of income in foreign currencies and from transactions that involve foreign currency denominated assets and liabilities. In addition, certain tax incentives designed to promote exporting activities are provided.

2. Taxation of income derived from foreign operations

Two different regimes apply to U.S. taxpayers that control business operations in foreign countries; which rules apply depends on whether the business operations are conducted directly, for example, through a foreign branch, or indirectly through a separately incorporated foreign company.[3] U.S. persons that conduct foreign operations directly (that is, not through a foreign corporation) include income (or loss) from those operations on their U.S. tax return for the year the income is earned or the loss is incurred. The United States taxes that income currently, and detailed rules are provided regarding the translation into U.S. dollars of amounts with respect to the foreign operations. The foreign tax credit (discussed below at Part I.A.3.) may reduce or eliminate the U.S. tax on that income, however. U.S. persons that conduct foreign operations through a foreign corporation generally pay no U.S. tax on the income from those operations until the foreign corporation repatriates its earnings to the United States. The income appears on the U.S. owner's tax return for the year it comes home, and the United States imposes tax on it at such time. The foreign tax credit may reduce the U.S. tax.[4]

A repatriation from a foreign corporation ends deferral and triggers immediate U.S. tax. In the case of any foreign corporation, an actual dividend payment is a repatriation that ends deferral and any U.S. recipient must include the dividend in income. In the case of a "controlled foreign corporation" (defined below), an investment in U.S. property, such as a loan to the lender's U.S. parent or the purchase of U.S. real estate, is also a deemed repatriation that ends deferral (sec. 956). Similarly, in the case of such a controlled foreign corporation, an investment of certain earnings in excess passive assets, such as foreign certificates of deposits, is also treated as a deemed repatriation that ends deferral (sec. 956A).

The Code currently sets forth the following anti-deferral regimes: the controlled foreign corporation rules (secs. 951-964); passive foreign investment company (PFIC) rules (secs. 1291-1297); the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and rules for foreign investment companies (sec. 1246) and electing foreign investment companies (sec. 1247).

[3] To the extent that foreign corporations operate in the United States rather than in foreign countries, they generally pay U.S. tax like U.S. corporations.

[4] The foreign corporation itself generally will not pay U.S. tax unless it has income effectively connected with a trade or business carried on in the United States, or has certain generally passive types of U.S. source income.

The operation and application of these regimes are briefly described in the following sections.

a. Controlled foreign corporations

General rules

A controlled foreign corporation ("CFC") is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957).[5] Stock ownership includes not only stock owned directly, but also all stock owned indirectly or constructively (sec. 958).

Deferral of U.S. tax on undistributed income of a CFC is not available for certain kinds of income (referred to as "subpart F income"). When a CFC earns subpart F income, the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income. In effect, the Code treats those U.S. shareholders as having received a current distribution out of the subpart F income. In addition, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the corporation's earnings invested in U.S. property and in excess passive assets for the taxable year. The foreign tax credit may reduce the U.S. tax on such inclusions.

Subpart F income typically is income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)-(5)). Subpart F income does not include the foreign corporation's income that is effectively connected with the conduct of a trade or business within the United States, which income is subject to current tax in the United States (sec. 952(b)).

The subpart F income of a CFC is limited by its current earnings and profits (sec. 952(c)). Under this rule, current deficits in earnings and profits in any income category, including nonsubpart F income categories, reduce subpart F earnings and profits and, thus, subpart F income. In addition, accumulated deficits in a CFC's earnings and profits generated by certain activities in prior years may be used to reduce its subpart F income generated by similar activities in the current year.

Earnings and profits of a CFC that are (or previously have been) included in the incomes of the U.S. shareholders are not taxed again when such earnings are actually distributed to the U.S. shareholders (sec. 959(a)(1)). Similarly, such previously taxed income is not included in the incomes of the U.S. shareholders in the event that such earnings are invested in U.S. property (sec. 959(a)(2)) or invested in excess passive assets (sec. 959(a)(3)). Previously taxed income actually distributed from a lower-tier CFC to a higher-tier CFC is disregarded in determining the subpart F income of the higher-tier CFC that is included in the income of the

[5] CFC is defined differently in the case of a foreign corporation engaging in certain insurance activities (see secs. 953(c) and 957(b)).

U.S. shareholders. In the event that stock in the CFC is transferred subsequent to the income inclusion but prior to the actual distribution of previously taxed income, the transferee shareholder is similarly exempt from tax on the distribution to the extent of the proven identity of shareholder interest.

Attribution of ownership

In determining stock ownership for purposes of the CFC rules, a U.S. person generally is considered to own a proportionate share of stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or estate of which the U.S. person is a shareholder, partner, or beneficiary (sec. 958(a)).

Additional rules for constructive ownership apply for purposes of determining whether or not a U.S. person is a U.S. shareholder (within the meaning of sec. 951(b), as discussed above), whether or not the foreign corporation meets the relevant definition of control (within the meaning of secs. 957(a), 957(b), or 953(c)(1), as discussed above), and whether or not two persons are related (within the meaning of sec. 954(d)(3)), but not for purposes of including amounts in a shareholder's gross income under section 951(a). These constructive ownership rules include, among other rules, provisions treating an individual as owning stock owned, directly or indirectly, by the individual's spouse, children, grandchildren, and parents; a 10-percent shareholder of a corporation as owning its proportionate share (100 percent, in the case of a more-than-50-percent shareholder) of stock owned, directly or indirectly, by the corporation; a partner or beneficiary as owning its proportionate share (100 percent, in the case of a more-than-50-percent partner or beneficiary) of stock owned, directly or indirectly, by the partnership or estate; a corporation as owning all stock owned, directly or indirectly, by 10-percent shareholders; a partnership or estate as owning all stock owned, directly or indirectly, by its partners or beneficiaries; and the holder of an option as owning the stock subject to the option (sec. 958(b)). However, these constructive ownership rules do not operate to treat stock owned by a nonresident alien individual as owned by a U.S. citizen or a resident alien individual (sec. 958(b)(1)).

Foreign base company income

Subpart F income, which is taxed currently to the 10-percent U.S. shareholders of a CFC, includes foreign base company income. Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). In computing foreign base company income, amounts of income in these five categories are reduced by allowable deductions properly allocable, under regulations, to such amounts of income (sec. 954(b)(5)).

Foreign personal holding company income

One major category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally consists

of passive income such as interest, dividends, annuities, net gains from sales of property which does not generate active income, net commodities gains, net foreign currency gains, related party factoring income, and certain rents and royalties. Other special provisions apply in the application of the subpart F regime. These rules include de minimis and full inclusion rules and an exception for certain income subject to high foreign taxes.

The Code provides an exclusion from subpart F foreign personal holding company income for rents and royalties received in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). Under this active trade or business test, rents from a retail car-leasing business involving substantial maintenance, repair, and marketing activities, for example, are excluded from subpart F, while rental income from lease-financing transactions is not.

Also excluded from subpart F income are certain dividends and interest received from a related corporation organized and operating in the same foreign country as the recipient, and certain rents and royalties received from a related corporation for the use of property within the country in which the recipient was created or organized (sec. 954(c)(3)). This exclusion, however, is subject to a look-through rule that takes into account the subpart F income of related-party payors. Under the look-through rule, interest, rent, and royalty payments do not qualify for the exclusion to the extent that such payments reduce subpart F income of the payor. Thus, if the income of the payor corporation consists entirely of nonsubpart F income, then the related party exclusions apply in full. However, to the extent that the payor corporation receives subpart F income which is reduced by its payment of interest, rent, or royalties, then such payment is treated as subpart F income to a related party recipient, notwithstanding the general rules of section 954(c)(3).

For this purpose, a related person is defined as any individual, corporation, partnership, trust, or estate that controls or is controlled by the CFC, or any individual, corporation, partnership, trust, or estate that is controlled by the same person or persons that control the CFC (sec. 954(d)(3)). Control with respect to a corporation means ownership of more than 50 percent of the corporation's stock (by vote or value). Control with respect to a partnership, trust, or estate means ownership of more than 50 percent of the value of the beneficial interests of the partnership, trust, or estate. Ownership includes stock or interests owned directly, indirectly, or constructively under the attribution rules described above.

Other categories of foreign base company income

Other categories of foreign base company income include foreign base company sales and services income, consisting respectively of income attributable to related party purchases and sales routed through the income recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. Foreign base company income also includes foreign base company shipping income. Finally,

foreign base company income generally includes "downstream" oil-related income, that is, foreign oil-related income other than extraction income.

Foreign base company sales income generally consists of sales income deflected to a CFC located in a country that is neither the origin nor the destination of the goods (sec. 954(d)). For example, foreign base company sales income would include gain realized by a CFC that is incorporated in a low-tax foreign country on the sale of a U.S.-manufactured item to an unrelated party for use in a high-tax foreign country if the foreign corporation had purchased the item from its controlling U.S. shareholder.

Foreign base company services income includes income from services performed (1) for or on behalf of a related party and (2) outside the country of the CFC's incorporation (sec. 954(e)). This rule taxes U.S. shareholders who contrive to provide services through controlled corporations established in low-tax countries. Treasury regulations provide that the services of the foreign corporation will be treated as performed for or on behalf of the related party if, for example, a party related to the foreign corporation furnishes substantial assistance to the foreign corporation in connection with the provision of services (Treas. Reg. sec. 1.954-4(b)(1)(iv)).

Foreign base company shipping income includes income derived from or in connection with the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or from or in connection with the performance of services directly related to the use of any such aircraft or vessel, or from the sale or exchange or other disposition of any such aircraft or vessel (sec. 954(f)). Foreign base company shipping income also includes any income derived from a space or ocean activity.

Foreign base company oil-related income generally includes all oil-related income (as defined in sec. 907(c)(2) and (3)) other than income derived from a source within a foreign country in connection with either (1) oil or gas which was extracted from a well located in that foreign country, or (2) oil, gas, or a primary product of oil or gas which is sold by the foreign corporation or a related person for use or consumption within that foreign country, or is loaded in that country on a vessel or aircraft as fuel for that vessel or aircraft (sec. 954(g)). An exception is available for any foreign corporation that, together with related persons, does not constitute a large oil producer.

Insurance income

In general

Subpart F insurance income is another category of income that is subject to current taxation under subpart F (sec. 953). Subpart F insurance income includes any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than that in which the insurer is cre-

ated or organized.[6] For this purpose, a qualified insurance branch of a CFC may be treated as a corporation created or organized in the country of its location (sec. 964(d)). In addition, investment income associated with same-country risk insurance is also included in subpart F income as foreign personal holding company income. Thus, for an insurance CFC, deferral generally is limited to underwriting income from same-country risk insurance.

For purposes of subpart F insurance income, a CFC is specially defined to include, in addition to any corporation that meets the usual test of 50-percent ownership by 10-percent shareholders (discussed above), any foreign corporation that satisfies a test of 25-percent ownership by 10-percent shareholders if more than 75 percent of the corporation's gross premium income is derived from the reinsurance or issuance of insurance or annuity contracts with respect to third-country risks (sec. 957(b)).

Any CFC engaged in the insurance business may elect to be treated as a U.S. corporation generally for all purposes under the Code (sec. 953(d)). A foreign corporation making the election is treated under the general rules of the Code as if it transferred its assets to a domestic corporation in a reorganization. Dividends paid out of earnings and profits of certain pre-election years are treated as coming from a foreign corporation. An electing corporation that terminates its election is treated under the general rules of the Code as a domestic corporation that transferred its assets to a foreign corporation in a reorganization.

Related person (captive) insurance income

Subpart F insurance income that is related person insurance income generally is taxable under subpart F to an expanded category of U.S. persons (sec. 953(c)). For purposes of taking into account such income under subpart F, the U.S. ownership threshold for CFC status is reduced to 25 percent or more. Any U.S. person who owns (directly, indirectly, or constructively) any stock in a CFC, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income. Certain exceptions apply to these special subpart F rules for related person (captive) insurers.

Premiums received by a captive insurer that is subject to the expanded application of the subpart F rules, like premiums received by an ordinary offshore insurer that is subject to subpart F, generally remain subject to the excise tax on insurance premiums paid to foreign insurers (secs. 4371-4374), absent a treaty exemption. However, the excise tax does not apply to income treated as effectively connected with the conduct of a U.S. business under the "effectively connected" election. This is consistent with the exemption from the excise tax generally accorded to premiums that are effectively connected with the conduct of a U.S. business.

[6] In addition, subpart F applies to income attributable to an insurance contract in connection with same-country risks as the result of an arrangement under which another corporation receives a substantially equal amount of premiums for insurance of other-country risks.

Certain income relating to international boycotts and other violations of public policy

Subpart F income also includes three categories of income relating to international boycotts and other violations of public policy. The first category includes the portion of the CFC's current income, other than amounts otherwise subject to current U.S. taxation, attributable (under sec. 999) to participation in an international boycott (sec. 952(a)(3)). Generally, a person is treated as participating in an international boycott if he agrees as a condition of doing business directly or indirectly with a foreign country, or a national of a foreign country, to do, or refrain from doing, certain acts. The second category includes the sum of any illegal bribes, kickbacks, or other payments by or on behalf of the corporation directly or indirectly to an official, employee, or agent in fact of a government, where such payments would be unlawful under the Foreign Corrupt Practices Act of 1977 if they were paid by a U.S. person (sec. 952(a)(4)).[7] The third category includes income derived from any foreign country during a period in which the taxes imposed by that country are denied eligibility for the foreign tax credit under section 901(j) pursuant to the implementation of U.S. foreign policy.

Treatment of investments in U.S. property and in excess passive assets

As discussed above, a U.S. shareholder of a CFC generally is taxable on its pro rata share of the CFC's subpart F income. In addition, a U.S. shareholder generally is taxable on its pro rata share of the lesser of (1) the CFC's average investment in U.S. property, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis, or (2) the CFC's current or accumulated earnings and profits to the extent that such earnings have not been previously taxed as earnings invested in U.S. property or in excess passive assets; but only to the extent that such lesser amount exceeds the amount of such earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B), 956, and 959). Similarly, a U.S. shareholder generally is taxable on its pro rata share of the lesser of (1) the CFC's average investment in excess passive assets, to the extent that such investment exceeds the earnings and profits that were previously taxed on that basis, or (2) the CFC's current or accumulated earnings and profits[8] to the extent that such earnings have not been previously taxed as earnings invested in U.S. property or in excess passive assets; but only to the extent that such lesser amount exceeds the amount of such earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(C), 956A, and 959).[9]

Special rules with respect to gain from certain sales or exchanges of stock in certain foreign corporations

If a U.S. person sells or exchanges stock in a foreign corporation, or receives a distribution from a foreign corporation that is treated

[7] Payments such as these are not deductible under the Code (sec. 162(c)).

[8] Accumulated earnings and profits are taken into account for this purpose only to the extent that they were accumulated in taxable years beginning after September 30, 1993.

[9] See Part I.C. below for a more detailed discussion of the provisions of section 956A.

as an exchange of stock, and, at any time during the five-year period ending on the date of the sale or exchange, the foreign corporation was a CFC and the U.S. person was a 10-percent shareholder (counting stock owned directly, indirectly, and constructively), then the gain recognized on the sale or exchange is included in the shareholder's income as a dividend, to the extent of the earnings and profits of the foreign corporation which were accumulated during the period that the shareholder held stock while the corporation was a CFC (sec. 1248).[10] For this purpose, earnings and profits of the foreign corporation do not include amounts that had already been subject to current U.S. taxation (whether imposed on the foreign corporation itself or the U.S. shareholders), such as amounts included in gross income under section 951, amounts included in gross income under section 1247 (applicable to foreign investment companies) amounts included in gross income under section 1293 (applicable to certain passive foreign investment companies) or amounts that were effectively connected with the conduct of a trade or business within the United States (sec. 1248(d)). The Code provides certain special rules to adjust the proper scope and application of section 1248 (sec. 1248(e)-(i)). Amounts subject to treatment under section 1248, in accordance with their characterization as dividends, carry deemed-paid foreign tax credits that may be claimed by corporate taxpayers under section 902.

Information reporting requirements

Each U.S. person that controls a foreign corporation is required to report certain information to the IRS with respect to the foreign corporation (sec. 6038(a)). The required information pertains to the stock ownership, capitalization, assets and liabilities, and earnings of the corporation, as well as transactions between the corporation and related persons, plus such other information as may be specified in regulations. Penalties for failure to comply with the requirements of section 6038(a) include a dollar penalty (sec. 6038(b)) and a reduction in the amount of foreign tax credits that may be claimed by the controlling U.S. person (sec. 6038(c)). Control for these purposes means ownership of more than 50 percent of the vote or value of the stock, including stock owned indirectly or by attribution (sec. 6038(e)).

b. Passive foreign investment companies

The 1986 Tax Reform Act (the "1986 Act") established an anti-deferral regime for passive foreign investment companies ("PFICs") and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," where electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders pay tax on income realized from a PFIC and an interest charge which is attributable to the value of defer-

[10] Special limitation applies in the case of the sale or exchange by an individual of stock held as a long-term capital asset (sec. 1248(b)).

ral. (See Part I.B. below for a more detailed discussion of the provisions relating to PFICs.)

c. Foreign personal holding companies

General rules

Congress enacted the foreign personal holding company rules (secs. 551-558) to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (by vote or value) of a foreign corporation that has primarily foreign personal holding company income, that corporation will be a foreign personal holding company. In that case, all the foreign corporation's U.S. shareholders are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income.

A foreign corporation is a foreign personal holding company if it satisfies both a stock ownership requirement (sec. 552(a)(2)) and a gross income requirement (sec. 552(a)(1)).[11] The stock ownership requirement is satisfied if, at any time during the taxable year, more than 50 percent of either (1) the total combined voting power of all classes of stock of the corporation that are entitled to vote, or (2) the total value of the stock of the corporation, is owned (directly, indirectly, or constructively) by or for five or fewer individual citizens or residents of the United States. The gross income requirement is satisfied initially if at least 60 percent of the corporation's gross income is foreign personal holding company income. Once the corporation is a foreign personal holding company, however, the gross income threshold each year is only 50 percent until the expiration of either one full taxable year during which the stock ownership requirement is not satisfied, or three consecutive taxable years for which the gross income requirement is not satisfied at the 50-percent threshold.

Foreign personal holding company income generally includes passive income such as dividends, interest, royalties (but not including active business computer software royalties), and rents (if rental income does not amount to 50 percent of gross income) (sec. 553(a)). It also includes, among other things, gains (other than gains of dealers) from stock and securities transactions, commodities transactions, and amounts received with respect to certain personal services contracts. Certain exceptions apply to dividend and interest received from related persons. If a foreign personal holding company is a shareholder in another foreign personal holding company, the first company includes in its gross income, as a dividend, its share of the undistributed foreign personal holding company income of the second foreign personal holding company.

If a foreign corporation is a foreign personal holding company, all of its undistributed foreign personal holding company income is treated as distributed as a dividend on a pro-rata basis to all of its U.S. shareholders, including U.S. citizens, residents, and corporations (sec. 551(b)). That is, although only the five largest individual

[11] Excluded from characterization as foreign personal holding companies are corporations that are exempt from tax under subchapter F (sec. 501 and following) of the Code, as well as certain corporations that are organized and doing business under the banking and credit laws of a foreign country (sec. 552(b)).

shareholders count in the determination of foreign personal holding company status, all individual U.S. shareholders as well as U.S. persons other than individuals may be subject to current tax on their pro rata shares of the undistributed income of the foreign personal holding company. The undistributed foreign personal holding company income that is deemed distributed is treated as recontributed by the shareholders to the foreign personal holding company as a contribution to capital. Accordingly, the earnings and profits of the corporation are reduced by the amount of the deemed distribution (sec. 551(d)), and each shareholder's basis in his or her stock in the foreign personal holding company is increased by the shareholder's pro rata portion of the deemed distribution (sec. 551(e)).

Attribution of ownership

The foreign personal holding company provisions contain constructive ownership rules that determine whether a foreign corporation is more than 50 percent owned by five or fewer U.S. citizens or residents. These rules generally treat an individual as owning stock owned, directly or indirectly, by or for his or her partners, brothers and sisters spouse, ancestors, and lineal descendants. However, ownership of stock actually owned by a nonresident alien is not attributed to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants who do not own stock in the foreign corporation. For example, a foreign corporation 40 percent of whose shares belong to a U.S. citizen and 60 percent of whose shares belong to the nonresident alien sister of the U.S. citizen will be a foreign personal holding company if it meets the other criteria for foreign personal holding company status. Similarly, ownership of stock actually owned by a nonresident alien will not be attributed to the alien's U.S. partners if the alien's U.S. partners do not own, directly or indirectly, any stock in the foreign corporation and if the alien's partners do not include members of the same family as a U.S. citizen or resident who owns, directly or indirectly, any stock in the foreign corporation. For example, if the nonresident alien partner of a U.S. citizen owns 60 percent of a foreign corporation, while a second U.S. citizen (who is wholly unrelated to the first U.S. citizen and to the nonresident alien) owns the remaining 40 percent, the foreign corporation is not a foreign personal holding company.

These constructive ownership rules also apply to deem income to be foreign personal holding company income in two cases: (1) when a foreign corporation has contracted to furnish personal services that an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation has performed, is to perform, or may be designated to perform; and (2) when an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation is entitled to use corporate property and when the corporation in any way receives compensation for use of that property. This latter rule prevents foreign corporations from avoiding foreign personal holding company status by generating what appear to be large amounts of rental income.

Information reporting requirements

Each U.S. citizen or resident who is an officer, director, or 10-percent shareholder of a foreign personal holding company is required to report to the Internal Revenue Service certain information with respect to the corporation (sec. 6035). The required information pertains to the stock ownership and income of the corporation, plus such other information as may be specified in regulations.

d. Personal holding companies

In addition to the corporate income tax, the Code imposes a tax at the rate of 39.6 percent on the undistributed income of a personal holding company (sec. 541). This tax substitutes for the tax that would have been incurred by the shareholders on dividends actually distributed by the personal holding company. A personal holding company generally is defined as any corporation (with certain specified exceptions) if (1) at least 60 percent of its adjusted gross income for the taxable year is personal holding company income, and (2) at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals (sec. 542(a)).

This definition is very similar to that of a foreign personal holding company, discussed above, but does not depend on the U.S. citizenship or residence status of the shareholders. However, the specified exceptions to the definition of a personal holding company preclude the application of the personal holding company tax to, among others, any foreign personal holding company, most foreign corporations owned solely by nonresident alien individuals, and any PFIC (paragraphs (5), (7), and (10) of sec. 542(c)). Therefore, the personal holding company tax could apply to only a small class of foreign corporations, such as foreign corporations with at least 60 percent but less than 75 percent passive-type income, and majority owned by a group of five or fewer individuals of whom at least one is a U.S. person and at least one of whom is a nonresident alien.

e. Accumulated earnings tax

In addition to the corporate income tax, the Code also imposes a tax, at the rate of 39.6 percent, on the accumulated taxable income of any corporation (with certain exceptions) formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed (secs. 531, 532(a)). The specified tax-avoidance purpose generally is determined by the fact that the earnings and profits of the corporation are allowed to accumulate beyond the reasonable needs of the business (sec. 533). Like the personal holding company tax, the accumulated earnings tax acts as a substitute for the tax that would have been incurred by the shareholders on dividends actually distributed by the corporation.

The accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or PFIC (sec. 532(b)). These exceptions, along with the current inclusion of subpart F income in the gross incomes of the U.S. shareholders of a

CFC, have resulted, in practice, in very limited application of the accumulated earnings tax to foreign corporations.

f. Foreign investment companies

A foreign investment company generally is defined as any foreign corporation that either is registered under the Investment Company Act of 1940 (as amended) as a management company or as a unit investment trust, or is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities or commodities or any interest (including a futures or forward contract or option) in securities or commodities, at a time when 50 percent or more of the vote or value of the stock is held (directly or indirectly) by U.S. persons (sec. 1246(b)). In the case of the sale or exchange of stock in a foreign investment company, gain on the sale generally is treated as ordinary income to the extent of the taxpayer's ratable share of the undistributed earnings and profits of the foreign investment company (sec. 1246(a)). However, if a foreign investment company so elected by December 31, 1962, it can avoid the application of section 1246 to its shareholders by annually distributing at least 90 percent of its taxable income (determined as if the foreign corporation were a domestic corporation), and complying with such information-reporting and other administrative requirements as the Secretary of the Treasury deems necessary (sec. 1247).

g. Coordination among anti-deferral regimes

If an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the CFC rules and under the foreign personal holding company rules, that item of income is included only under the CFC rules (sec. 951(d)). This rule of precedence operates only to the extent that the CFC rules and the foreign personal holding company rules overlap on an item-by-item basis. Income includible under only one set of rules (foreign personal holding company rules or subpart F rules) is includible under that set of rules. A taxpayer taxable under subpart F on amounts other than subpart F income (on such items as investments in U.S. property or investments in excess passive assets) is taxable under subpart F whether or not the taxpayer is also taxable on the undistributed foreign personal holding company income of the foreign corporation under the foreign personal holding company rules.

If an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the CFC rules and under the rules relating to the current taxation of income from certain PFICs, that item of income is included only under the CFC rules (sec. 951(f)). In addition, if an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the CFC rules and under the rules relating to the current taxation of income from electing foreign investment companies, that item of income is included only under the foreign investment company rules (sec. 951(c)). Any amount that is taxable under only one set of rules is included in gross income pursuant to that set of rules.

In the case of a foreign corporation that is both a foreign personal holding company and a PFIC, to the extent that the income of the foreign corporation would be taxable to a U.S. person both under the foreign personal holding company rules and under section 1293 (relating to current taxation of income of certain PFICs), that income is treated as taxable to the U.S. person only under the foreign personal holding company rules (sec. 551(g)).

In the case of a PFIC that is a qualified electing fund, the amount of income treated as a dividend on a sale or exchange of stock in a CFC (under sec. 1248) does not include any amount of income included previously under the qualified electing fund rules to the extent that amount of income has not been distributed from the PFIC prior to the sale or exchange of the stock.

In the case of a PFIC that is a qualified electing fund and that owns stock in a second-tier PFIC that is also a qualified electing fund, amounts distributed by the second-tier fund to the first-tier fund that have been included previously in income by U.S. investors—because they are deemed to own stock in the second-tier fund—are not to be included in the ordinary earnings of the first-tier fund. This rule prevents U.S. persons from including amounts in income twice. This relief provision also applies in the case of a second- (or lower-) tier PFIC that is a qualified electing fund and that is also a CFC. In this case, amounts that are included in a U.S. person's income under the subpart F provisions and that would have been included under the qualified electing fund provisions (but for the coordination provision of sec. 951(f)) are prevented from being included in income again under this relief provision.

In the case of a PFIC that is not a qualified electing fund, the Code eliminates the potential for double taxation by providing for proper adjustments to excess distributions for amounts that are taxed currently under the Code's other current inclusion rules. Thus, for example, excess distributions will not include any amounts that are treated as previously taxed income under section 959(a) when distributed by a CFC that is also a PFIC that is not a qualified electing fund.

As noted above, the personal holding company tax does not apply to any foreign personal holding company or PFIC, and the accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or PFIC.

Section 1246 does not apply to the earnings and profits of any foreign investment company for any year after 1986 if the company is a PFIC for that year (sec. 1297(b)(7)). In addition, an electing foreign investment company under section 1247 is excluded from the definition of a PFIC (sec. 1296(d)).

3. Avoidance of double taxation through granting of foreign tax credit

a. Overview

Because the United States taxes U.S. persons on their worldwide income, Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign source income; once by the foreign country where the income is earned, and again by the United States. The foreign tax credit generally allows

U.S. taxpayers to reduce the U.S. income tax on their foreign income by the foreign income taxes they pay on that income. The foreign tax credit does not operate to offset U.S. income tax on U.S. source income.

A credit against U.S. tax on foreign income is allowed for foreign taxes paid or accrued by a U.S. person (sec. 901).[12] In addition, a credit is allowed to a U.S. corporation for foreign taxes paid by certain foreign subsidiary corporations, and deemed paid by the U.S. corporation upon a dividend received by, or certain other income inclusions of, the U.S. corporation relating to earnings of the foreign subsidiary (the "deemed-paid" or "indirect" foreign tax credit) (sec. 902).

The foreign tax credit provisions of the Code are elective on a year-by-year basis. In lieu of electing the foreign tax credit, taxpayers generally are permitted to deduct foreign taxes (sec. 164(a)(3)). No deduction of foreign taxes is permitted, however, for any creditable taxes paid or accrued during a taxable year with respect to which the taxpayer elects application of the foreign tax credit (sec. 275(a)(4)(A)).

As a general rule, foreign tax credits cannot be used to offset more than 90 percent of the pre-foreign tax credit tentative minimum tax (determined without the net operating loss deduction, the special energy deduction, and investment tax credits).[13]

A foreign tax credit limitation, which is calculated separately for various categories of income, is imposd to prevent the use of foreign tax credits to offset U.S. tax on U.S. source income. For foreign tax credit limitation purposes, losses for any taxable year in the separate foreign tax credit limitation categories offset U.S. source income only to the extent that the aggregate amount of such losses exceeds the aggregate amount of foreign income earned in other categories (i.e., only to the extent that there is an overall foreign loss) (sec. 904(f)(5)(A)). Separate limitation losses (to the extent that they do not exceed total foreign income for the year) are allocated on a proportionate basis among (and operate to reduce) the separate limitation categories in which the entity earns income in the loss year (sec. 904(f)(5)(B)). Losses in all separate limitation categories are subject to this rule. A separate limitation loss recharacterization rule applies to foreign losses allocated to foreign income pursuant to the above rule (sec. 904(f)(5)(C)).

If a taxpayer's losses from foreign sources exceed its foreign source income, the excess ("overall foreign loss") may reduce the taxpayer's U.S. source taxable income and, hence, its U.S. tax. To eliminate a double benefit (that is, the reduction of U.S. tax just noted and, later, full allowance of a foreign tax credit with respect to foreign source income), an overall foreign loss recapture rule was enacted in 1976. Under this rule, a portion of foreign taxable income earned after an overall foreign loss year is treated as U.S.

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[12] Taxpayer may elect to use the accrual basis of accounting for purposes of determining when foreign taxes are eligible for the credit notwithstanding the method of accounting generally employed in keeping its books (sec. 905(a)). Adjustments are required in certain cases where the amount of taxes accrued differs from the amount of taxes actually paid by the taxpayer (see sec. 905(c)).

[13] Certain domestic corporations operating solely in one foreign country with which the U.S. has an income tax treaty in effect are not subject to the 90-percent limitation on the use of the foreign tax credit if certain other specified criteria are satisfied (sec. 59(a)(2)(C)).

source taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit) (sec. 904(f)(1)).

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years (sec. 904(c)). For purposes of determining excess foreign tax credit amounts, the foreign tax credit separate limitation rules apply. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits are carried back or forward only as taxes allocable to that category notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another category for that year.

An affiliated group of corporations filing a consolidated return (hereinafter referred to as a "consolidated group") must choose the benefits of the foreign tax credit (as opposed to taking deductions for foreign income taxes) on a group-wide basis (Treas. Reg. sec. 1.1502-4(a)). Each foreign tax credit limitation to which a consolidated group is subject varies directly with the ratio of the foreign source taxable income of the group subject to that limitation to the entire taxable income of the group (Treas. Reg. sec. 1.1502-4(c) and (d)).

b. Deemed-paid foreign tax credit

U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder (sec. 902(a)). This is the "deemed-paid" or "indirect" foreign tax credit.

A U.S. corporation may also be deemed to have paid taxes paid by a second or third tier foreign corporation. That is, where a foreign corporation that satisfies certain ownership requirements pays a dividend to a qualifying U.S. corporate shareholder, then for purposes of deeming the U.S. corporation to have paid foreign tax, the foreign corporation may be deemed to have paid a share of the foreign taxes paid by a second-tier foreign corporation of which the first foreign corporation owns at least 10 percent of the voting stock, and from which the first foreign corporation received dividends. The same principle applies between a second and a third-tier foreign corporation. No taxes paid by a second- or third-tier foreign corporation are deemed paid by the first foreign corporation unless the product of the percentage ownership at each level from the U.S. corporation down equals at least 5 percent (sec. 902(b)). Foreign taxes paid below the third tier are not eligible for the deemed-paid credit. A deemed-paid credit generally is also available with subpart F inclusions (sec. 960(a)).[14] Moreover, a deemed-paid credit generally is also available with respect to inclusions

[14] Unlike the deemed-paid credit for actual dividend distributions, the deemed-paid credit for subpart F inclusions can be available to individual shareholders in certain circumstances if an election is made (sec. 962)).

under Code section 1293 from PFICs by U.S. corporations meeting the requisite ownership threshold (sec. 1293(f)).[15]

The amount of foreign tax eligible for the indirect credit is added to the actual dividend or inclusion (the dividend or inclusion is said to be "grossed-up") and included in the U.S. corporate shareholder's income to treat the shareholder as if it had received its proportionate share of pre-tax profits and paid its proportionate share of foreign tax (sec. 78)). Under this formula for computing the indirect credit, for any given dividend amount in the numerator of the fraction, a greater amount of profits in the denominator of the fraction produces a smaller amount of foreign taxes allowed as a credit.

For purposes of computing the deemed-paid foreign tax credit, dividends or subpart F inclusions are considered made first from the post-1986 pool of all the distributing corporation's accumulated and earnings and profits.[16] Accumulated earnings and profits for this purpose include the earnings and profits of the current year undiminished by the current distribution or subpart F inclusion (sec. 902(c)(1)). Pooling applies only to earnings and profits derived in taxable years beginning after December 31, 1986. Dividends in excess of the accumulated pool of post-1986 undistributed earnings and profits are treated as paid out of pre-1987 accumulated profits under the ordering principles of pre-1986 Act law (sec. 902(c)(6)).[17] In the case of a foreign corporation that does not have a 10-percent (direct or indirect) U.S. shareholder who qualifies for the deemed-paid credit, pooling begins with the first day of the first taxable year in which there is such a 10-percent shareholder (sec. 902(c)(3)).

c. Foreign tax credit limitation

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. source income; rather, it should only reduce U.S. tax on its foreign source income. Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned from domestic sources.

Under present law, the foreign tax credit is subject to an overall limitation. That is, the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year (sec. 904(a)). In addition, the foreign tax credit limitation is calculated separately for various categories of income generally referred to as "separate limitation categories." That is, the total amount of the credit for foreign taxes *on income in each category* may not exceed the same proportion of

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[15] Special rules are provided for purposes of computing the deemed-paid foreign tax credit in the case of a U.S. corporation receiving an excess distribution from an interest-charge PFIC (see sec. 1291(g)).

[16] Earnings and profits computations for these purposes are to be made under U.S. concepts. *Goodyear Tire & Rubber Company & Affiliates v. United States*, 493 U.S. 132 (1989).

[17] In the case of an actual dividend distribution, the share of foreign tax paid by the foreign corporation that was eligible for the indirect credit was based under pre-1986 Act law on the share of that corporation's accumulated profits attributable to a particular taxable year that was repatriated as a dividend to the U.S. corporate shareholder. Foreign taxes paid for a particular year were eligible for the deemed-paid credit only to the extent that there were accumulated profits for that year and then only in proportion to the share of such accumulated profits that was attributed to the dividend distribution. Distributions were considered made first out of the most recently accumulated profits of the distributing corporation.

the taxpayer's U.S. tax which the taxpayer's foreign source taxable income *in that category* bears to the taxpayer's worldwide taxable income for the taxable year. In order to compute the foreign tax credit limitations, then, a taxpayer must determine the portion of its taxable income that falls into each applicable category, and determine the portion of its foreign taxes related to the income in each category.[18]

The separate limitation categories include passive income, high-withholding-tax interest, financial services income, shipping income, dividends received by a corporation from each noncontrolled section 902 corporation, dividends from a domestic international sales corporation (DISC) or former DISC, certain distributions from a foreign sales corporation (FSC), and taxable income of a FSC attributable to foreign trade income (sec. 904(d)). Income not in a separate limitation category is referred to in the regulations as "general limitation income." Also, a special limitation applies to the credit for taxes imposed on foreign oil and gas extraction income (sec. 907(a)). Under the look-through rules discussed below, subpart F inclusions with respect to the CFC, and dividends, interest, rents, and royalties received from it by its U.S. shareholders are subject to separate limitations to the extent attributable to the foreign corporation's income subject to the separate limitations.

A separate limitation generally is applied to a category of income for one of three reasons: the income's source (foreign or U.S.) can be manipulated; the income typically bears little or no foreign tax; or the income often bears a rate of foreign tax that is abnormally high or in excess of rates on other types of income. Applying a separate limitation to a category of income prevents the use of foreign taxes imposed on one category of income to reduce the U.S. tax on other categories of income. For example, the separate limitation for passive income generally prevents taxes imposed by a high-tax country (e.g., Germany) on manufacturing income from offsetting U.S. tax on interest earned on a bank deposit placed in a country that does not tax the interest in the hands of the U.S. taxpayer (or its subsidiaries).

d. Look-through rules

Dividends, interest, rents, royalties, and subpart F income inclusions received from CFCs by their U.S. shareholders generally are subject to the general limitation or to the various separate limitations (as the case may be) in accordance with look-through rules that take into account the extent to which the income of the payor is itself subject to one or more of these limitations (sec. 904(d)(3)(A)).[19] A dividend received from a CFC by a U.S. shareholder of that corporation, for example, is not automatically treated

[18] Treas. Reg. sec. 1.904-6(a)(i). Taxes are related to income if the income is included in the base upon which the tax is imposed. A withholding tax generally is related to the income from which it is withheld. If a tax is related to more than one separate category (because it is imposed on income in more than one category), then the tax is apportioned on an annual basis among the relevant categories according to a formula provided in regulations (Treas. Reg. sec. 1.904-6(a)(ii)). That formula is the foreign tax subject to apportionment multiplied by the ratio of net income subject to that tax that is included in a separate category to the total net income subject to that tax.

[19] The look-through rules do not apply with respect to income that would fall in one of the following separate limitation categories: Dividends from a DISC or former DISC, taxable income attributable a FSC's foreign trade income, and FSC distributions (sec. 904(d)(3)(F)(i)).

as 100-percent passive income even though it is income of a kind which would be subpart F foreign personal holding company income if earned by another foreign corporation.

A portion of any dividend received from a CFC in which the recipient is a U.S. shareholder is treated as general limitation income or as income of each separate limitation category on the basis of a separate limitation income ratio (sec. 904(d)(3)(D)). For each of these foreign tax credit limitation categories, the separate limitation income ratio of a dividend equals the separate limitation earnings and profits out of which the dividend was paid divided by the total earnings and profits out of which the dividend was paid. Dividends are considered to be paid first from the post-1986 multi-year pool of the distributing corporation's accumulated profits (in the case of actual distributions) rather than, as under pre-1986 Act law, from the most recently accumulated profits of the distributing corporation.

Interest, rents, and royalties received or accrued from a CFC in which the payee is a U.S. shareholder generally are treated as income subject to the general limitation or as income subject to each separate limitation category to the extent properly allocable to income of the CFC subject to each of these limitations (sec. 904(d)(3)(C)). Under this rule, for example, royalties paid to a parent corporation by a foreign subsidiary that itself earns only general limitation income are treated as general limitation income. Similarly, interest paid to a parent financial institution by a subsidiary that itself earns only high withholding tax interest is treated as high withholding tax interest.

Interest payments or accruals by a CFC to a U.S. shareholder with respect to the corporation (or to another CFC related to such a U.S. shareholder) are allocated first to gross subpart F foreign personal holding company income of the corporation that is passive, to the extent of such income (Treas. Reg. sec. 1.904-5(c)(2)(ii)(C)).[20] Interest paid by a CFC to a U.S. shareholder is treated as first attributable to passive income under the theory that it generally would be as easy for the ultimate passive income recipient to have received the passive income directly as to have channeled it through a related corporation. In addition, this treatment of passive income prevents avoidance of tax through the use of back to back loans.

Inclusions under section 951(a)(1)(A) with respect to income of a CFC generally are treated as income subject to the general limitation or as income subject to each separate limitation category to the extent the amount so included is attributable to income of the CFC subject to each of these limitations (sec. 904(d)(3)(B)).[21]

The general look-through rule for subpart F inclusions may be illustrated as follows: Assume that a CFC wholly owned by a U.S. corporation earns $200 of net income. Ninety-five dollars of the in-

[20] The general subpart F related person definition applies to determine whether a CFC is related to a U.S. shareholder for purposes of the direct allocation provision.

[21] Inclusions of this type generally consist of the sum of the taxpayer's pro rata share of subpart F income (e.g., subpart F insurance income and foreign base company income) and amounts of previously excluded subpart F income withdrawn from investments in less developed countries or in shipping operations (sec. 951(a)(1)(A)). Any amounts included in gross income under section 78 to the extent attributable to these types of subpart F inclusions are treated as subpart F inclusions for this purpose, not as dividends (sec. 904(d)(3)(G)).

come is foreign base company shipping income and $5 is interest from unrelated parties that is foreign personal holding company income for subpart F purposes. The remaining $100 is non-subpart F general limitation income. No foreign tax is imposed on the income. The shipping and foreign personal holding company income is subpart F income taxed currently to the U.S. parent corporation. Since $95 of the $100 subpart F inclusion is attributable to income of the foreign corporation subject to the separate limitation for shipping income, $95 of the subpart F inclusion is treated as separate limitation shipping income of the parent corporation. Since $5 of the subpart F inclusion is attributable to income of the foreign corporation subject to the separate limitation for passive income, $5 of the subpart F inclusion is treated as separate limitation passive income of the parent corporation. Any future dividend from the CFC from its $100 of other earnings will consist solely of general limitation income.

Subpart F inclusions triggered by an investment of earnings of a CFC in U.S. property ("section 956 inclusions") are subject to the look-through rule applicable to dividends discussed below (sec. 904(d)(3)(G)). Section 956 inclusions are subject to the look-through rule for dividends rather than for subpart F inclusions generally because section 956 inclusions, like dividends, are drawn pro rata from earnings and profits; they differ from foreign base company income inclusions in that they are not specifically identified with particular earnings of a CFC.

Look-through rules similar to the rules applicable to subpart F inclusions apply to inclusions from passive foreign investment companies under section 1293 (sec. 904(d)(3)(I)). That is, any amount included under section 1293 is treated as income in a separate category to the extent such amount is attributable to income in such category.

For purposes of applying the look-through rules, a U.S. corporation's income "gross-up" for deemed-paid foreign taxes (sec. 78) is treated as increasing the corporation's subpart F inclusion to the extent that the gross-up is attributable to such a subpart F inclusion. To the extent that the gross-up is attributable to a dividend or a section 956 inclusion, the gross-up is treated as a dividend for look-through purposes (sec. 904(d)(3)(G)). Under this approach, for example, a single $100 inclusion consisting of $80 of subpart F foreign personal holding company income and a $20 gross-up for the foreign taxes deemed paid on the $80 is subject to one look-through rule (that for subpart F inclusions under Code section 951(a)(1)(A)) rather than two (the subpart F and dividend look-through rules).

4. Tax treaties and foreign tax laws

a. United States tax treaty policy in general

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons, bilateral treaties limit the amount of foreign tax that may be imposed by the treaty partner on U.S. residents. Treaties also supplement, to some extent, the U.S. statutory rules governing the foreign tax credit that the Unit-

ed States will provide to U.S. residents.[22] Reciprocally, these treaties limit the amount of U.S. tax that may be imposed on residents of the treaty partner, in addition to modifying the internal treaty country tax rules applicable to its own residents with respect to their U.S. income.

Thus, with respect to outbound investment by U.S. persons, treaties largely serve the function of modifying the tax effect of foreign statutory laws. Treaties also serve in the outbound context to ensure the creditability of taxes imposed by the treaty country where income was earned (the "source country") in computing the amount of tax owed by the U.S. resident to the United States. Treaties may also provide procedures under which inconsistent positions taken by both treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries. Although foreign laws constitute a critical component of the tax position a U.S. person with foreign income may face, comprehensive discussion of foreign internal laws generally is beyond the scope of this pamphlet. The discussion below focuses on current U.S. policy toward treaty issues that affect the foreign tax liabilities and foreign tax credits of U.S. persons.

The preferred tax treaty policies of U.S. administrations have been expressed from time to time in model treaties and agreements. In addition, the OECD has published model tax treaties. The United Nations has also published a model treaty for use between developed and developing countries. The Treasury Department, which together with the State Department is responsible for negotiating tax treaties, last published a proposed model income tax treaty in June 1981.[23] It is understood that the Treasury's current working model (that is, its current preferred income tax treaty negotiating position) includes provisions different from those in the 1981 model, in part due to the substantial changes in U.S. statutory international tax provisions since mid-1981.[24] The OECD last published a model income tax treaty in 1992 ("the OECD model").[25] The OECD model treaty is accompanied by extensive commentary, expressing views of the OECD Committee on Fiscal Affairs and, where relevant, separate views of particular member countries. In addition, the OECD Committee on Fiscal Affairs publishes from time to time more detailed reports on particular international tax issues. The United Nations last published a model income tax treaty in 1980 ("the U.N. model").

b. Treasury's 1981 model income tax treaty

The 1981 U.S. model income tax treaty contains many provisions of particular significance with respect to outbound investment. Some of these provisions are briefly described below.

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[22] For a detailed discussion of the general legal framework within which income tax treaties operate, and their significance for the U.S. income of foreign residents, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990, p. 43 *et seq.*

[23] The Treasury also proposed a model estate, inheritance, gift, and generation-skipping transfer tax treaty in 1980.

[24] For example, since 1986 Treasury has completed several new treaties, since ratified. In some cases they amended the existing treaties in order to conform them to the 1986 Act changes in the Code. In doing so, they necessarily departed in some ways from the 1981 model.

[25] The OECD last published a model estate, inheritance and gift tax treaty in 1983.

Business profits attributable to a permanent establishment

Under the U.S. model, there is no foreign taxation of business profits of the enterprise of a qualified U.S. resident unless the enterprise carries on business within the treaty country through a permanent establishment in that country; that is, a fixed place of business through which the business of an enterprise is wholly or partly carried on. The model describes in detail the characteristics relevant to determine whether something is a permanent establishment. The term includes especially a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. The model specifies that a duration of more than twelve months is necessary before treating a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, as a permanent establishment (Article 5.3).

The U.N. model, by contrast, would permit the source country to treat a building site, a construction, assembly, or installation project or supervisory activities in connection therewith as a permanent establishment where the site project or activities continue for more than 6 months. It would also permit the furnishing of services within a country to be treated as a permanent establishment in that country if the activities continue (for the same or a connected project) within the country for a period or periods aggregating more than 6 months within any 12-month period. Under the U.S. model, the term permanent establishment does not include the maintenance of a fixed place of business solely for the purpose of carrying on for the enterprise activities of a preparatory or auxiliary character.

Under the U.S. model, a U.S. resident is not deemed to have a permanent establishment in the treaty country merely because it carries on business in the treaty country through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. The U.N. treaty would not treat as an independent agent one whose activities are devoted wholly or almost wholly on behalf of the enterprise.

Where a person to whom the foregoing U.S. model rule does not apply is acting on behalf of the U.S. resident, and has and habitually exercises in the treaty country an authority to conclude contracts in the name of the U.S. resident, and that agent's activities on behalf of the U.S. resident go beyond the scope of what the U.S. resident could itself do in the treaty country without constituting a permanent establishment, the U.S. resident is deemed to have a permanent establishment in the treaty country in respect of any activities which the agent undertakes for the U.S. resident. The U.N. treaty would also permit the source country to treat the agent as a permanent establishment of the U.S. resident where the agent has no such authority but habitually maintains in the source country a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the U.S. resident. Also under the U.N. treaty, an insurance enterprise of a U.S. resident would be deemed to have a permanent establishment in the treaty country if it collected premiums in the treaty country or insured risks

situated therein through a person other than an independent agent.

The U.S. model provides that the fact that a U.S. company entitled to treaty benefits controls or is controlled by a company resident in the treaty country (or carrying on business in the treaty country) does not of itself cause the company resident in the treaty country (or carrying on business in the treaty country) to be treated as a permanent establishment of the U.S. company.

In addition, the U.S. model provides that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. The U.N. model adds a limited "force of attraction rule" which would also allow the country in which the permanent establishment is located to attribute to the permanent establishment sales in that country of goods or merchandise of the same or similar kind as those sold through the permanent establishment, and to attribute to the permanent establishment other business activities carried on in that country of the same or similar kind as those effected through the permanent establishment.

Where the U.S., OECD, and U.N. models expressly provide for the allocation of worldwide executive and general administrative expenses in determining business profits attributable to a permanent establishment, the U.S. model also specifies research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part of the enterprise that includes the permanent establishment) (Article 7.3).

Dividends and branch taxes

The U.S. model permits taxation of dividends by the residence country of the payor the "source country"), but limits the rate of source country tax in cases where the beneficial owner of the dividends is a resident of the other treaty country.[26] In that case, the model allows not more than a 5-percent gross-basis tax if the beneficial owner is a company which owns at least 10 percent of the payor's voting stock (a "direct investor"), and in any other case (a "portfolio investor") not more than a 15-percent gross-basis tax. (Under the OECD model, the 5-percent rate is not available unless the beneficial owner of the dividends is a company other than a partnership which holds directly at least 25 percent of the capital of the dividend payor.) The term "dividend" as used in the model is limited to income from shares or other rights, not being debt-claims, participating in profits, and income from other corporate rights which is subjected by the source country to the same tax treatment as income from shares.

The U.S. model also allows for so-called "second level withholding taxes" provided that the dividends are paid out of profits attributable to a permanent establishment in the taxing country, and the gross income of the dividend payor attributable to such permanent establishment constituted at least 50 percent of the company's

[26] This limitation does not apply to dividend income attributable to a source country permanent establishment through which a resident of the other treaty country carries on business, or to income attributable to a fixed base from which a resident of the other treaty country performs independent services. In the case of such income, it would be subject to the ordinary net-basis taxation rules applicable to any other income attributable to the permanent establishment or fixed base.

gross income from all sources. However, since 1986 it has apparently been the Treasury's goal to negotiate treaties allowing for a branch profits tax at a rate equal to the direct dividend withholding rate.[27] Thus, the second-level withholding provision of the 1981 model may fairly be said to be obsolete.

The U.N. model expressly leaves to case-by-case bilateral negotiation the particular percentage limit to be imposed on source country taxation of dividends.

Interest and royalties

The U.S. model generally allows no tax to be imposed by a treaty country on interest or royalty income derived and beneficially owned by a resident of the other treaty country. By contrast, the OECD model would permit up to 10-percent gross-basis taxation of interest by the treaty country in which the interest arises. The U.N. model expressly leaves to case-by-case bilateral negotiation the particular percentage limit to be imposed on source country taxation of interest or royalties, as it does in the case of limits on source country taxation of dividends.

The U.S. model defines interest as income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits. More recently signed treaties may or may not signal a change in the preferred U.S. negotiating position on the issue of whether income from a debt-claim carrying a right to participate in profits constitutes interest. For example, the 1989 German treaty provides that payments are not interest within the meaning of the treaty, and may be taxed in the source country under its internal laws, if the payments are deductible in determining the profit of the payor, and are made under arrangements, *including debt obligations*, carrying the right to participate in profits (Articles 10.5 and 11.2). The 1989 treaties with India and Finland also permit source country taxation of income from a debt-claim participating in profits, but without regard to whether those payments are deductible (Art. 10.3). On the other hand, the 1990 Spanish treaty and the 1988 Indonesian treaty follow the U.S. model definition.

The U.S. model defines royalties as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (not including cinematographic films or films or tapes used for radio or television broadcasting), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience. The term also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof.

The U.S. model prohibits imposing second level withholding tax on interest (that is, taxing interest paid by a resident of the other treaty country, which interest is not received by a person subject to tax in the first country either as a resident or as a nonresident

[27] See, e.g., Articles IV and VIII of the 1988 U.S.-France income tax protocol, Article 10 of the Tunisian, 1989 German and 1989 Finnish treaties, Article 14 of the Indian and Spanish treaties, and Article 11 of the Indonesian treaty.

subject to net basis tax) unless the interest arises in the taxing state and is not paid to a resident of the other treaty country.[28]

Shipping and air transport

The U.S. model provides that profits of an enterprise of a treaty country from the operation of ships or aircraft in international traffic shall be taxable only in that country. The U.S. model similarly provides that profits of an enterprise of a treaty country from the use, maintenance, or rental of containers used in international traffic shall be taxable only in the residence country. This treatment of container leasing income is found in neither the OECD nor the U.N. model treaty.

Other income

The U.S. model provides that items of income, wherever arising, that are not dealt with in the articles of the treaty are taxable only by the recipient's country of residence. By contrast, the U.N. model states that items of income of a resident of a treaty country not dealt with in the other treaty articles and arising in the other treaty country may also be taxed in that other country.

Relief from double taxation

The U.S. model treaty obligates the United States to allow its residents and citizens as a credit against U.S. income tax: (a) income taxes paid to the treaty country by the U.S. person, and (b) in the case of a U.S. company owning at least 10 percent of the voting stock of a company resident in the treaty country, and from which the U.S. company receives dividends, the treaty country income tax paid by the distributing company with respect to the profits out of which the dividends are paid. However, the model preserves U.S. internal law by subjecting this right to the foreign tax credit to the provisions and limitations of U.S. law as it may be amended from time to time without changing the general principle of the model provision. Further, the model states that credits allowed for treaty country taxes shall not in any taxable year exceed that proportion of the U.S. tax on income which taxable income arising in the treaty country bears to total taxable income.

Further, the model requires that for foreign tax credit purposes under the treaty, the United States must deem income taxable by the treaty country as income from sources in the treaty country. The model also provides that for this purpose the United States will deem income fully protected by the treaty from taxation by the other country as U.S. source income.

Creditable taxes

A standard article in every treaty specifies the U.S. and foreign taxes covered by the treaty. The model treaty provides that such

[28] This provision is obsolete with respect to the U.S. taxation of foreign residents in light of the repeal of second level withholding tax on interest in the 1986 Act, and its replacement with the branch level interest tax. However, the model definition of where interest "arises" might be relevant in any future treaties that permit (presumably, contrary to what is thought to be Treasury's currently preferred negotiating position) imposition of a branch level interest tax. For this purpose, the model treats interest as arising either in the payor's residence country, or the country in which the payor has a permanent establishment or fixed base if the indebtedness on which the interest is paid was incurred in connection with, and the interest is borne by, that permanent establishment or fixed base.

covered taxes shall be considered income taxes for purposes of the credit article, and contemplates the possibility that such a tax might be creditable solely by reason of the treaty. The model says nothing further about the foreign taxes considered appropriate for such treatment. In practice, treaties with Norway and the United Kingdom have granted U.S. residents the right to foreign tax credits for Norwegian and U.K. petroleum revenue taxes. In other cases where such credits have been proposed in treaties, the Senate has not consented to the treaty. The Senate Foreign Relations Committee has suggested that treaties not be used in the future to handle foreign tax credit issues which can best be dealt with either legislatively or administratively.[29]

Nondiscrimination

In a departure from the scope of other provisions of the U.S. model, the model nondiscrimination clause imposes restrictions not only on foreign country taxation and U.S. Federal income taxation, but also on gift and estate tax and on all other nationally imposed taxes "of every kind and description," as well as on all taxes imposed by any state or other political subdivision or local authority thereof. The model provides that nationals of a treaty country, wherever they may reside, shall not be subjected in the other country to any taxation (or any requirement connected therewith) which is other or more burdensome than the taxation and connected requirements to which nationals of that other country in the same circumstances are or may be subjected. Similarly, the taxation of a permanent establishment which an enterprise of a treaty country resident has in the other country (the source country) generally shall not be less favorably levied in the source country than the taxation levied on enterprises of source country residents carrying on the same activities. Thus, for example, the treaty country branch of a U.S. bank generally would be entitled to treaty country tax parity with a treaty country bank. Further, an enterprise of a source country resident, the capital of which is wholly or partly owned or controlled by residents of the other country, shall not be subjected in the source country to any taxation (or any requirement connected therewith) which is other or more burdensome than the taxation and connected requirements to which other similar source country enterprises are or may be subjected. Thus, a treaty country corporation wholly owned by a U.S. resident, for example, generally would be entitled to tax parity with similarly situated treaty country corporations wholly owned by local persons. Finally, the model generally provides (subject to certain arm's length standards) that interest, royalties, and other disbursements paid by a treaty country resident to a resident of the other country shall, for the purposes of determining the taxable profits of the payor, be deductible under the same conditions as if they had been paid to a resident of the source country.

Mutual agreement procedures

The U.S. model provides for a treaty country resident or national to obtain relief, from the competent authority of the person's home

[29] Exec. Rep. No. 98-23, 98th Cong., 2d Sess. 12 (1984).

country, from actions of either or both countries that are considered to result in taxation in violation of the treaty. The model requires the competent authorities to endeavor to resolve such a case by mutual agreement where the home country authority cannot do so unilaterally.

c. Imputation-related benefits

One provision typically sought by the Treasury in treaty negotiations is one that relates only to countries with integration of their individual and corporate tax systems. United States law generally does not, of course, provide the benefit of integration. A country that provides a tax credit to dividend recipients based on taxes paid by the dividend payor—a so-called "imputation credit"—typically will *not* provide that credit by internal law to dividend recipients who are not taxpayers in that country. When negotiating with such a country, Treasury may seek a reduction in the treaty country dividend withholding tax rate for U.S. dividend recipients below the rate in the model treaty, plus a refund by the treaty country to the U.S. dividend recipient of imputed corporate-level taxes, in excess of the otherwise applicable withholding taxes. There are no such provisions set forth, however, in the 1981 U.S. model.

For example, the U.S. income tax treaties with the United Kingdom and Germany, which have imputation credit systems, generally provide U.S. portfolio investors (i.e., noncorporate U.S. investors and U.S. companies owning less than 10 percent of the voting shares of a company resident in the treaty country) with a credit based on at least a portion of the imputation credit a U.K. or German resident would have received. The U.S. treaty with the United Kingdom further provides U.S. direct investors (i.e., U.S. companies owning 10 percent or more of the voting shares of a company resident in the treaty country) with a credit equal to one-half of the credit which an individual U.K. resident would be entitled to were he the recipient of the dividend. On the other hand, the U.S. income tax treaties with Canada and Finland, which countries also have imputation systems, do not allow U.S. shareholders in companies resident in those jurisdictions any portion of the imputation credit provided by those countries' statutes to domestic shareholders in domestic companies. Under present U.S. income tax treaties, no imputation system country except the United Kingdom allows U.S. *direct* investors any portion of the imputation credit provided its own residents.

d. Departures from the model tax treaty

Of the income tax treaties currently in effect, many diverge in one or more respects from the 1981 model. These divergences may reflect the age of a particular treaty or the particular balance of interests between the United States and the treaty partner.

Other countries' preferred tax treaty policies may differ from those of the United States depending on their internal tax laws and depending upon the balance of investment and trade flows between those countries and their potential treaty partners. For example, where the United States has sought to negotiate treaties that waive all source country tax on interest, royalties, and personal property rents paid to residents of the other treaty country, certain

capital importing countries may be interested in imposing relatively high source country tax on such income. Consequently, treaties with such countries tend to reflect provisions found in the U.N. model treaty and not in the U.S. model. They may have higher dividend withholding rates, and non-zero interest, royalty, and personal property rental withholding rates, and may permit a building site, or construction or installation project, or mineral resources extraction site, to constitute a permanent establishment although lasting 12 months or less.

Thus, for example, the 1988 treaty with Indonesia, the 1989 treaty with India, and the 1985 treaty (modified by the 1989 protocol) with Tunisia provide for source country taxation of interest at rates generally between 10 and 15 percent, direct investment dividends at 14 or 15 percent, portfolio dividends at rates between 15 and 25 percent, and royalties at rates of 10 to 20 percent. Activities of a U.S. enterprise that last as little as 4 to 6 months in these countries may result in the enterprise being treated as having a permanent establishment under those treaties.

As another example, the other country may demand other concessions in exchange for agreeing to U.S. terms. For example, in cases where a country taxes certain local business operations at a relatively low rate, or a zero rate of income tax (whether to attract manufacturing capital to that country or for other reasons), that country may seek to enter into "tax-sparing" treaties with capital exporting countries. That is, the first country may seek to enter into treaties under which the capital exporting country gives up its tax on the income of its residents derived from sources in the first country, regardless of the extent to which the source country has imposed tax with respect to that income. While other capital exporting countries have agreed to such treaties, the United States has rejected proposals by certain foreign countries to enter into such tax-sparing arrangements.[30] India, for example, sought to include a tax-sparing provision in the 1989 treaty. The treaty was concluded without such a provision, but with a provision allowing India to impose up to a 25-percent withholding tax on portfolio dividends paid by Indian companies to U.S. residents. By contrast, in a treaty with Japan, India would agree to limit its portfolio dividend withholding taxes to 15 percent in the case of Indian company dividends paid to a Japanese resident; in the same treaty, Japan agreed to provide tax-sparing credits.

Finally, where the import of the treaty negotiation, at least with respect to U.S. residents, is to reduce taxes imposed under a particular foreign statute, key issues for the treaty may of necessity be ones not addressed in the model. Imputation credit provisions, described above, are an example of non-model provisions that may be sought by the Treasury. Although the OECD, the U.N., and the Treasury models reflect a standardization of terms that is quite helpful, it is in the nature of a treaty's function as a bridge between two actual tax systems that at least one of the parties to the negotiations might fairly be expected to seek to diverge from the

[30] However, the United States has represented to several countries (e.g., India and China) that should it enter into a tax-sparing treaty in the future, the U.S. tax treaties with those countries would be amended (by the usual treaty procedures) to provide tax-sparing benefits.

models at times, in order to account for particular features of a particular tax system.

B. Passive Foreign Investment Companies

As mentioned above, the 1986 Act established an anti-deferral regime for passive foreign investment companies (PFICs) and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," where electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders pay tax on income realized from a PFIC and an interest charge which is attributable to the value of deferral.

1. General rules

a. Definition of a PFIC

A PFIC is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income (sec. 1296(a)). In the case of a CFC as well as any other corporation that so elects, the asset test is applied using the adjusted bases of the corporation's assets rather than their fair market value (sec. 1296(a)(2)). Passive income for these purposes generally means income that satisfies the definition of foreign personal holding company income under subpart F (as discussed above in Part I.A.); except as provided in regulations, however, passive income does not include certain active-business banking or insurance income (or, in the case of the U.S. shareholders of a CFC, securities income), or certain amounts received from a related party (to the extent that the amounts are allocable to income of the related party which is not passive income, as discussed below) (sec. 1296(b)). Passive assets for this purpose are those assets that produce or are held for the production of passive income. Assets that are property which, in the hands of the foreign corporation, are inventory property (as defined in sec. 1221(1)), or are held by a regular dealer in that property, and are specifically identified as such inventory, are treated as nonpassive assets, even where that property generates foreign personal holding company income (as defined in sec. 954(c)), such as in the case of a securities broker-dealer that holds debt securities as inventory (Treasury Notice 89-81, 1989-2 C.B. 399). In addition, special rules apply for the purpose of measuring the assets of the foreign corporation in the case of leased property and certain intangible property.

The Code treated certain leased property as assets held by the foreign corporation for purposes of the PFIC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months. The measure of leased property for purposes of applying the asset test is the unamortized portion of the present value

of the payments under the lease. Present value is determined, under regulations, as of the beginning of the lease term, and, except as provided in regulations, by using a discount rate equal to the applicable Federal rate determined under the rules applicable to original discount instruments (sec. 1274(d)), substituting under those rules the term of the lease for the term of the debt instrument. In applying those rules, options to renew or extend the lease are not taken into account. Also, the special rule to be applied under section 1274(d)(2) in the case of a sale or exchange is disregarded. Property leased by a corporation is not taken into account in testing for PFIC status under the asset test either if the lessor is a related person (as that term is defined under the foreign base company rules) with respect to the lessee, or if a principal purpose of leasing the property was to avoid the PFIC provisions.

In measuring the assets of a CFC for purposes of the PFIC asset test, adjusted basis is modified to take into account certain research and experimental expenditures and certain payments for the use of intangible property that is licensed to the CFC. First, the aggregate adjusted basis of the total assets of the CFC is increased by the total amount of research and development expenditures made by the CFC, for qualified research or experimental expenditures (as defined for purposes of Code section 174 and the Treasury regulations thereunder), taking into account payments and expenditures (including cost-sharing payments) made in the current taxable year and the two most recent preceding taxable years. In addition, the aggregate adjusted basis of the total assets of the CFC is increased by the amount of three times the total payments made during the taxable year to unrelated persons and related U.S. persons for the use of intangible property with respect to which the CFC is a licensee, and which the CFC uses in the active conduct of a trade or business. Payments made to related foreign persons are not taken into account. For purposes of this rule, intangible property is defined as under section 936(h)(3)(B) of the Code.

Special exceptions from PFIC classification apply to start-up companies (sec. 1297(b)(2)) and corporations changing businesses during the taxable year (sec. 1297(b)(3)). In both such cases, a corporation may have a substantially higher proportion of passive assets (and passive income, in some cases) than at other times in its history.

b. Look-through rules

In determining whether foreign corporations that own subsidiaries are PFICs, look-through treatment is provided in certain cases (sec. 1296(c)). Under this look-through rule, a foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder's income in applying the income test, and the stock or debt investment is eliminated from the shareholder's assets in applying the asset test.

In addition to the look-through rule applicable to 25-percent-owned subsidiaries, interest, dividends, rents, and royalties re-

ceived from related persons that are not subject to section 1296(c) look-through treatment are excepted from treatment as passive income to the extent that, under regulations prescribed by the Secretary, those amounts are allocable to income of the payor that is not passive income (sec. 1296(b)(2)(C)).[31] As a corollary, the characterization of the assets that generate the income will follow the characterization of the income so that, for example, a loan to a related person will be treated as a nonpassive asset if the interest on the loan is treated as nonpassive income. Together, these rules provide that earnings of certain related corporations, which earnings would be excluded from foreign personal holding company income under the related-person same-country exception of subpart F (sec. 954(c)(3)) if distributed to the shareholders, are subject to look-through treatment whether or not the related party is 25-percent owned.

In addition, stock of certain U.S. corporations owned by another U.S. corporation which is at least 25-percent owned by a foreign corporation is treated as a nonpassive asset (sec. 1297(b)(8)). Under this rule, in determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by a 25-percent owned domestic corporation is treated as an asset which does not produce passive income (and is not held for the production of passive income), and income derived from that stock is treated as income which is not passive income. Thus, a foreign corporation, in applying the look-through rule available to 25-percent owned corporations, is treated as owning nonpassive assets in these cases. This rule does not apply, however, if, under a treaty obligation of the United States, the foreign corporation is not subject to the accumulated earnings tax, unless the corporation agrees to waive the benefit under the treaty. This rule is designed to mitigate the potential disparate tax treatment between U.S. individual shareholders who hold U.S. stock investments through a U.S. holding company and those who hold those investments through a foreign holding company. If a foreign investment company attempts to use this rule to avoid the PFIC provisions, it will be subject to the accumulated earnings tax and, thus, the shareholders of that company essentially will be denied deferral on the earnings of the foreign company, with an effect in some ways similar to application of the PFIC provisions.

2. Nonqualified funds

a. General rule

United States shareholders in PFICs that are not "qualified electing funds" pay U.S. tax and an interest charge based on the value of tax deferral at the time the shareholder disposes of stock in the PFIC or on receipt of an "excess" distribution (sec. 1291). Under this rule, gain recognized on disposition of stock in a nonqualified fund or on receipt of an "excess" distribution from a nonqualified fund is treated as ordinary income and is treated as earned pro rata over the shareholder's holding period of his or her investment during the time the foreign corporation was a PFIC,

[31] Related person is defined by reference to the related person definition in subpart F (that is, sec. 954(d)(3)).

and is taxed at the highest applicable tax rate in effect for each respective year. The interest charge imposed on gains and excess distributions is treated as interest for tax purposes.

b. Availability of foreign tax credits

Distributions from nonqualified funds are eligible for direct and deemed-paid foreign tax credits (under secs. 901 and 902) under the following method. The U.S. investor first computes the total amount of creditable foreign taxes with respect to the distribution it receives. This amount includes the amount of direct foreign taxes paid by the investor with respect to the distribution (for example, any withholding taxes) and the amount of the PFIC's foreign taxes deemed paid by the investor with respect to the distribution under section 902 (if any) to the extent the direct and indirect taxes are creditable under general foreign tax credit principles and the investor chooses to claim those taxes as a credit. The investor then determines the amount of the creditable foreign taxes that are attributable to the portion of the distribution that is an excess distribution (the "excess distribution taxes"). This determination is made by apportioning the total amount of creditable foreign taxes between the amount of the distribution that is an excess distribution and the amount of the distribution that is not an excess distribution on a pro rata basis. For purposes of determining the amount of the distribution from the PFIC (and the amount of the excess distribution), the gross-up under section 78 is included in the amount of money or other property received.

The U.S. investor then allocates the excess distribution taxes ratably to each day in the holding period of its stock. To the extent the taxes are allocated to days in taxable years prior to the year in which the foreign corporation became a PFIC and to the current taxable year, the taxes are taken into account for the current year under the general foreign tax credit rules. To the extent the taxes are allocated to days in any other taxable year (that is, to days in years on which the deferred tax amount is imposed), then the foreign tax credit limitation provisions of section 904 are applied separately to those taxes. Under this rule, the allocable taxes can reduce the aggregate increase in tax on which interest is computed, but not below zero. In the event the allocable taxes are in excess of any increase in tax, no interest will be due, but no carryover will be allowed since the foreign tax credit limitations are applied with respect to excess distributions occurring within each taxable year.

c. Definition of excess distribution

An "excess" distribution is any current year distribution in respect of a share of stock that exceeds 125 percent of the average amount of distributions in respect of the share of stock received during the 3 preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year) (sec. 1291(b)). The determination of an excess distribution excludes from the 3-year average distribution base that part of a prior-year excess distribution that is considered attributable to deferred earnings (i.e., that part of the excess distribution that was not allocable to pre-PFIC years and to the current year).

Regulatory authority is provided to disregard any nonrecognition provision of the Code on any transfer of PFIC stock (sec. 1291(f)). For example, regulations may treat a gift of stock in a nonqualified fund to a non-taxpaying entity, such as a charity or a foreign person, as a disposition for purposes of those rules in order that the deferred tax and interest charge attributable to that stock not be eliminated.

3. Qualified electing funds

A U.S. person who owns stock in a PFIC may elect that the PFIC be treated as a "qualified electing fund" with respect to that shareholder (sec. 1295), with the result that the shareholder must include currently in gross income his or her pro rata share of the PFIC's total earnings and profits (sec. 1293). This inclusion rule generally requires current payment of tax, absent a separate election to defer tax.

The election for treatment as a qualified electing fund, which is made at the shareholder level, is available only where the PFIC complies with the requirements prescribed in Treasury regulations to determine the income of the PFIC and to ascertain any other information necessary to carry out the purposes of the PFIC provisions. The effect of the election is to treat a PFIC as a qualified electing fund with respect to each electing investor so that, for example, an electing investor will not be subject to the deferred tax and interest charge rules of section 1291 on receipt of a distribution if the election has been in effect for each of the PFIC's taxable years for which the company was a PFIC and which includes any portion of the investor's holding period.

The amount currently included in the income of an electing shareholder is divided between a shareholder's pro rata share of the ordinary income of the PFIC and net capital gain income of the PFIC. The characterization of income, and the determination of earnings and profits, is made pursuant to general Code rules with two modifications. These modifications apply only when the qualified electing fund is also a CFC and the U.S. investor in the fund is also a U.S. shareholder in the CFC (as both terms are defined under subpart F).

Under the first modification, if the U.S. investor establishes to the satisfaction of the Secretary that an item of income derived by a fund was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of U.S. corporate tax, then that item of income is excluded from the ordinary earnings and net capital gain income of the fund for purposes of determining the U.S. investor's pro rata share of income.

Under the second modification, the qualified electing fund's ordinary earnings and net capital gain income do not include income from U.S. sources that is effectively connected with the conduct by the fund of a U.S. trade or business so long as that income is not exempt from U.S. taxation (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

Pro rata share of income generally is determined by aggregating a PFIC's income for the taxable year and attributing that income ratably over every day in the PFIC's year. Electing investors then include in income for the period in which they hold stock in the

PFIC their daily ownership interest in the PFIC multiplied by the amount of income attributed to each day.

As a special rule, the Code permits that, to the extent provided in regulations, if a qualified electing fund establishes to the Secretary's satisfaction that it maintains records that determine investors' pro rata shares of income more accurately than allocating a taxable year's income ratably over a daily basis (for example, by allocating a month's income ratably over a daily basis), the fund can determine the investors' pro rata shares of income on that basis. This provision is designed to allow those funds that maintain appropriate records to more accurately determine U.S. investors' pro rata shares of income, which may be important in cases where the investors own their stock for only parts of a year.

The distribution of earnings and profits that were previously included in the income of an electing shareholder under these rules is not treated as a dividend to the shareholder, but does reduce the PFIC's earnings and profits (sec. 1293(c)). The basis of an electing shareholder's stock in a PFIC is increased by amounts currently included in income under these rules, and is decreased by any amount that is actually distributed but treated as previously taxed under section 1293(c) (sec. 1293(d)).

Foreign tax credits are allowed against U.S. tax on amounts included in income from a qualified electing fund to the same extent, and under the same rules, as in the case of income inclusions from a CFC (sec. 1293(f)).

The Code provides special rules to characterize income inclusions from qualified electing funds for foreign tax credit purposes. In the case of a qualified electing fund that is also a CFC, where the U.S. person that has the income inclusion is a U.S. shareholder in the corporation (as defined under the subpart F rules), look-through treatment determines the foreign tax credit limitation characterization of the income inclusion. In addition, where the qualified electing fund is a noncontrolled section 902 corporation (as defined in sec. 904(d)(2)(E)) with respect to the taxpayer, the income inclusion is treated for foreign tax credit purposes as a dividend, and thus, is subject to the separate limitation applicable to those dividends. Where neither of the above conditions is satisfied, the income inclusion is characterized as passive income for foreign tax credit purposes.

U.S. investors in qualified electing funds may generally, subject to the payment of interest, elect to defer payment of U.S. tax on amounts included currently in income but for which no current distribution has been received (sec. 1294). An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest.

The disposition of stock in a PFIC terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. Disposition for this purpose generally means any transfer of ownership, regardless of whether the transfer constitutes a realization or recognition event under general Code rules. For example, a transfer at death or by gift of stock in a qualified electing fund is treated as a disposition for these purposes.

4. Special rules applicable to both types of funds

a. Coordination of section 1291 with taxation of shareholders in qualified electing funds

Gain recognized on disposition of stock in a PFIC by a U.S. investor, as well as distributions received from a PFIC in a year the PFIC is a qualified electing fund, are not taxed under the rules applicable to nonqualified funds (that is, sec. 1291) if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986 and which includes any portion of the investor's holding period (sec. 1291(d)(1)). Therefore, if for any taxable year beginning after December 31, 1986, a foreign corporation is a PFIC but is not a qualified electing fund with respect to the U.S. investor, gains and distributions in any subsequent year will be subject to the rules applicable to nonqualified funds. The section 1291 coordinating provision as it relates to distributions prevents a fund from retaining its annual income while it is not a qualified electing fund, and then distributing the accumulated income in a subsequent year after it becomes a qualified electing fund without incurring any interest charge.

Any U.S. person who owns stock in a PFIC which previously was not a qualified electing fund for a taxable year but which becomes one for the subsequent taxable year may elect to be taxed on the unrealized appreciation inherent in his or her PFIC stock up through the first day of the subsequent taxable year, pay all prior deferred tax and interest, and acquire a new basis and holding period in his or her PFIC investment (sec. 1291(d)(2)). Thereafter, the shareholder is subject to the rules applicable to qualified electing funds.

An alternative election is available to shareholders in a CFC. Under this alternative, instead of recognizing the entire gain in the value of his or her stock, a U.S. person that holds stock (directly or indirectly under the attribution rules) in a CFC (as defined for subpart F purposes) that is a PFIC and that becomes a qualified electing fund can elect to include in gross income as a dividend his or her share of the corporation's earnings and profits accumulated after 1986 and since the corporation was a PFIC. Upon this election, the U.S. person's stock basis is increased by the amount included in income and the shareholder is treated as having a new holding period in his or her stock. Thereafter, the shareholder is subject to the rules applicable to qualified electing funds. The total amount treated as a dividend under the above election is an excess distribution and is to be assigned, for purposes of computing the deferred tax and interest charge, to the shareholder's stock interest on the basis of post-December 31, 1986 ownership.

b. Attribution of ownership

In determining stock ownership, a U.S. person is considered to own his or her proportionate share of the stock of a PFIC owned by any partnership, trust, or estate of which the person is a partner or beneficiary (or in certain cases, a grantor), or owned by any foreign corporation if the U.S. person owns 50 percent or more of the value of the corporation's stock (sec. 1297(a)). However, if a U.S. person owns any stock in a PFIC, the person is considered to

own his or her proportionate share of any lower-tier PFIC stock owned by the upper-tier PFIC, regardless of the percentage of his or her ownership in the upper-tier PFIC. Under regulations, any person who has an option to acquire stock may be treated as owning the stock.

c. Anti-avoidance rules

The Code provides authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the PFIC provisions and to prevent circumvention of the interest charge (sec. 1297(d)). In addition, if a U.S. person is treated as owning stock in a PFIC by virtue of the attribution rules, regulations may treat any distribution of money or other property to the actual holder of the stock as a distribution to the U.S. person, and any disposition (whether by the U.S. person or the actual holder of the stock) which results in the U.S. person being treated as no longer owning the stock as a disposition by the U.S. person (sec. 1297(b)(5)).

C. Current Taxation of Earnings of a Controlled Foreign Corporation Invested in Excess Passive Assets Under Section 956A

1. Overview

As discussed in detail in Part I.A. above, the 10-percent U.S. shareholders of a CFC are subject to U.S. tax currently on their shares of certain earnings of the CFC. Under the subpart F rules, those U.S. shareholders are required to include in income currently for U.S. tax purposes their pro rata shares of the CFC's subpart F income. In addition, such U.S. shareholders are required to include in income currently for U.S. tax purposes their pro rata shares of the CFC's earnings invested in U.S. property. Finally, the 10-percent shareholders are required to include in income currently for U.S. tax purposes their pro rata shares of the CFC's earnings invested in "excess passive assets."

Section 956A, the provision requiring current inclusion of a CFC's earnings invested in "excess passive assets," was enacted in the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act"). Section 956A was enacted to limit the deferral of U.S. tax for CFCs that accumulate earnings without reinvesting them in active business assets.[32]

Under section 956A, the 10-percent U.S. shareholders of a CFC are generally subject to U.S. tax currently on their pro rata shares of the CFC's earnings and profits invested in excess passive assets during the taxable to the extent such earnings have not already been included in the shareholder's income. Current taxation under the excess passive assets provision is limited to earnings and profits accumulated by the CFC in taxable years beginning after September 30, 1993.

2. Operating rules

a. Definition of passive assets

For purposes of section 956A, a passive asset is any asset that either produces passive income as defined under the PFIC provi-

[32] Senate Committee on Finance, 103rd Cong., 1st Sess., *Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Finance* 37, 167-168 (Comm. Print 1993).

sions or is held for the production of such income, and that is not U.S. property within the meaning of sec. 956 (sec. 956A(c)(2)). As described in Part I.B. above, the definition of passive income contained in the PFIC provisions generally includes income that constitutes foreign personal holding company income under subpart F; however, passive income does not include certain active-business banking, insurance or securities brokerage income or certain amounts that are received from a related party and are allocable to non-passive income of such related party.

b. 25-percent threshold for excess passive assets

A CFC's excess passive assets for a taxable year is the excess, if any, of (1) the average of the amounts of passive assets held at the end of each quarter of the taxable year, over (2) 25 percent of the average of the amounts of total assets held at the end of each quarter of the taxable year (sec. 956A(c)(1)). Thus, the excess passive assets determination is made by comparing the CFC's average passive assets for the year to its average total assets for the year, rather than by making the comparison on a quarter by quarter basis and then taking the average. The excess passive assets calculation must be made using the adjusted bases of the CFC's assets as determined for the purpose of reporting the CFC's earnings and profits (sec. 956A(c)(1)). The calculation cannot be made using the fair market values of the CFC's assets.

c. Determination of CFC's assets

The look-through rules contained in the PFIC provisions are applicable in determining a CFC's assets for purposes of section 956A (secs. 956A(c)(3)(A) and 1296(c)). Under these look-through rules, a CFC that directly or indirectly owns at least 25 percent (by value) of the stock of another corporation is treated as owning its proportionate share of that other corporation's income and assets. Therefore, a CFC that holds 25 percent or more of the stock of another corporation is deemed to hold a share of that corporation's assets proportionate to its percentage ownership of the corporation's stock.

In calculating a CFC's assets for purposes of section 956A (and for purposes of the PFIC provisions), certain tangible property used, but not owned, by the CFC is included in the CFC's assets (secs. 956A(c)(3)(B) and 1297(d)). In addition, certain payments made by the CFC for research and development and for the license of certain intangible property are deemed to give rise to an increase in the CFC's assets (secs. 956A(c)(3)(C) and 1297(e)).

Tangible personal property of which the CFC is a lessee is treated as an asset of the corporation if the lease term is at least twelve months (sec. 1297(d)(1)). Under this rule, the adjusted basis of the leased property is deemed to be the unamortized portion of the present value of the payments under the lease (sec. 1297(d)(2)). However, leased property is not deemed to be an asset of the foreign corporation if the property is leased from a related person or if a principal purpose of the lease is to avoid either section 956A or the PFIC rule (sec. 1297(d)(3)).

Expenditures for research and development and certain payments made with respect to licensed intangible property are also treated as assets of a CFC (sec. 1297(e)(1)). The adjusted basis of a CFC's total assets is increased by an amount equal to its research and experimental expenditures (within the meaning of sec. 174) paid or incurred during the taxable year and the preceding two taxable years. To the extent that the CFC is reimbursed for any research and experimental expenditures, it is not permitted to increase its total assets for such amounts.

The adjusted basis of a CFC's total assets is also increased to include an amount equal to 300 percent of the total payments made during the taxable year for the use of intangible property (within the meaning of sec. 936(h)(3)(B)) of which the CFC is a licensee and which is used by the CFC in the active conduct of a trade or business (sec. 1297(e)(2)(A)). This rule does not apply, however, if the property is licensed from a foreign person that is a related person or if a principal purpose of the license is to avoid either section 956A or the PFIC provisions (sec. 1297(e)(2)(B)).

d. CFC grouping rules

Section 956A contains special rules for allocating passive assets among several CFCs that are related by ownership. These rules are designed to prevent 10-percent U.S. shareholders from avoiding the application of section 956A by isolating passive assets in separate CFCs that have no current or accumulated earnings. Under these rules, the excess passive assets determination is made with respect to the "CFC group" as a whole (sec. 956A(d)(1)(A)). The amount of excess passive assets so determined is then allocated to the members of the group in proportion to each member's share of the relevant earnings and profits of the CFC group (sec. 956A(d)(1)(B)).

In general, a CFC group is one or more chains of CFCs connected through stock ownership; under the CFC group rules, the top-tier CFC group member must own directly more than 50 percent (by vote or value) of the stock of a least one other CFC group member and more than 50 percent (by vote or value) of the stock of each other CFC group member must be owned, directly or indirectly, by other CFC group members (sec. 956A(d)(2)). In making the excess passive assets computation for a CFC group, it is intended that stock owned by one group member in another group member and intercompany loans between group members generally be disregarded. Accordingly, the look-through rules described above do not apply within a CFC group. However, it is intended that the stock ownership of all members of the CFC group in a nongroup member be aggregated for purposes of determining whether the 25-percent ownership threshold is met in applying the look-through rules.

3. Effect of section 956A

Section 956A first applied for taxable years of CFCs beginning after September 30, 1993 and for taxable years of U.S. shareholders in which or with which such taxable years end. Because many taxpayers have not yet filed their tax returns for the first taxable year to which section 956A applies, tax return information regarding the effect of section 956A is not yet available.

Some commentators have suggested that the provisions of section 956A may be avoided through restructuring of the operations of a CFC. Such restructuring could involve the conversion of passive assets of the CFC into active assets or the acquisition by the CFC of additional active assets; under either approach, the CFC's passive assets could be reduced below 25 percent of its total assets so the CFC would not have excess passive assets under section 956A.

Anecdotal evidence indicates that taxpayers in fact are avoiding the application of section 956A by restructuring the operations of CFCs. Some taxpayers have indicated that this restructuring has resulted in more overseas investment than would have been made if section 956A had not been enacted. Because a CFC's investment in an active foreign business asset could result in the avoidance of current U.S. tax under section 956A by reducing the CFC's ratio of passive assets to total assets to 25 percent or below, the level of return required to make a foreign investment opportunity attractive to the CFC would be reduced.

Restructuring undertaken to avoid the application of section 956A potentially involves both the acceleration of foreign investment by CFCs and the alteration of investment choices (e.g., investment by a CFC in active foreign assets instead of investment by the CFC's U.S. parent in active U.S. assets). However, some taxpayers may find the cost of restructuring prohibitive, and therefore would be subject to current inclusion under section 956A.

D. Foreign Sales Corporations

A portion of the export income of an eligible foreign sales corporation (FSC) is exempt from Federal income tax. In addition, a domestic corporation is allowed a 100-percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income. Thus, there generally is no corporate level tax imposed on a portion of the income from exports of a FSC.[33]

Typically, a FSC is a company owned by a U.S. company, such as manufacturer, that produces goods in the United States. The U.S. company either supplies the goods to the FSC for resale abroad to unrelated persons, or pays the FSC a commission in connection with its own sales to unrelated persons. Therefore, the income of the FSC, a portion of which is exempt under the FSC rules, equals the FSC's gross markup or gross commission income, less the expenses incurred by the FSC itself. Under the rules of the General Agreement on Tariffs and Trade (GATT), an exemption from tax on export income is permitted only if the economic processes which give rise to the income take place outside the United States. In conformity with these rules, a FSC must have a foreign

[33] The Code provided two similar provisions prior to the enactment of the foreign sales corporation provisions in 1984. Under provisions enacted in 1962, CFCs that qualified as export trade corporations were permitted to reduce their subpart F income by the amount of certain export trade income (secs. 970 and 971). No CFC may qualify as an export trade corporation unless it so qualified as of 1971. Under provisions enacted in 1971, domestic international sales corporations (DISCs), which are U.S. corporations, were permitted to defer U.S. taxation on certain export receipts (secs. 991-997). Upon enactment of the FSC provisions in 1984, a special rule permitted any DISC to transfer its deferred earnings, without tax, to a FSC. An interest charge is now imposed on the deferral of tax on the earnings of any remaining DISC (sec. 995(f)).

presence, it must have economic substance, and activities that relate to its export income must be performed by the FSC outside the U.S. customs territory. Furthermore, the income of the FSC must be determined according to statutorily specified transfer pricing rules which are intended to comply with GATT's requirement of arm's-length prices.

1. Foreign sales corporations generally

a. General requirements

In order to qualify to elect status as a FSC, a foreign corporation must have adequate foreign presence. To have adequate foreign presence, a foreign corporation must satisfy each of the following six requirements.

(1) *Foreign organization.*—The corporation must be created or organized under the laws of a foreign country or possession of the United States (sec. 922(a)(1)(A)).[34] If the corporation is organized in a foreign country, that country must be either (1) a party to an exchange of information agreement that meets the standards of the Caribbean Basin legislation (sec. 274(h)(6)(A)(i)) ("CBI Agreement"), or (2) an income tax treaty partner of the United States, provided the Secretary of the Treasury certifies that the exchange of information program with that country under the treaty is satisfactory, and the country of organization must be authorized to exchange information with respect to the FSC (sec. 927(e)(3)).

(2) *Shareholders.*—A FSC may have no more than 25 shareholders at any time during the taxable year (sec. 922(a)(1)(B)).

(3) *Preferred stock.*—A FSC may not have any preferred stock outstanding during the taxable year (sec. 922(a)(1)(C)).

(4) *Office and books of account outside the United States.*—A FSC must maintain an office located outside the United States, and must maintain a set of the permanent books of account at that office (sec. 922(a)(1)(D)).[35] The office need not be located in the country in which the FSC is organized; however, the office must be in a country which is either a party to a CBI agreement with the United States or an income tax treaty partner which the Treasury Department certifies as having a satisfactory exchange of information program under the treaty. In addition, a FSC must maintain at a location in the United States such books and records as are sufficient under Code section 6001 to establish the amount of gross income, deductions, credits, or other matters required to be shown in the FSC's tax return.

(5) *Board of directors.*—At all times during the taxable year, the FSC must have a board of directors which includes at least one individual who is not a resident of (but may be a citizen of) the United States (sec. 922(a)(1)(E)).

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[34] For purposes of this provision, a possession of the United States includes Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States, but does not include Puerto Rico (sec. 927(d)(5)).

[35] For this purpose, "United States" includes the Commonwealth of Puerto Rico (sec. 927(d)(3)).

(6) *Controlled group.*—A FSC may not be a member at any time during the taxable year of any controlled group of corporations of which a DISC is a member (sec. 922(a)(1)(F)).[36]

b. Small FSC

A FSC may elect to be a small FSC, provided that it is not a member of a controlled group of corporations which includes another FSC (unless the other FSC has also made a small FSC election) (sec. 922(b)).

2. Exempt foreign trade income

A portion of the foreign trade income of a FSC may be exempt from Federal income tax. To achieve this result, the exempt foreign trade income is treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States (sec. 921(a)). The portion of foreign trade income that is treated as exempt foreign trade income depends on the pricing rule used by the FSC. If the amount of income earned by the FSC is based on arm's-length pricing between unrelated parties, or between related parties under the rules of section 482, then exempt foreign trade income generally is 30 percent of the foreign trade income the FSC derives from a transaction (secs. 923(a)(2) and (6) and 291(a)(4)). For this purpose, foreign trade income does not include any income attributable to patents and other intangibles which do not constitute export property. If the income earned by the FSC is determined under the special administrative pricing rules, then the exempt foreign trade income generally is 15/23 of the foreign trade income the FSC derives from the transaction (secs. 923(a)(3) and (6) and 291(a)(4)).

Exempt foreign trade income is an exclusion from gross income of the FSC. Any deductions of the FSC properly apportioned and allocated to the foreign trade income derived by the FSC from a transaction are allocated on a proportionate basis between exempt and nonexempt foreign trade income (sec. 921(b)). Thus, deductions allocable to exempt foreign trade income may not be used to reduce the taxable income of the FSC.

3. Foreign trade income

a. In general

Foreign trade income is defined as the gross income of a FSC attributable to foreign trading gross receipts (sec. 923(b)). Foreign trade income includes both profits earned by the FSC from its own exports and commissions earned by the FSC from products or services exported by others.

Foreign trade income other than exempt foreign trade income (nonexempt foreign trade income) generally is treated as U.S. source income effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States (sec. 921(d)(1)). Thus, nonexempt foreign trade income generally is taxed currently and treated as U.S. source in-

[36] For this purpose, the term controlled group has the definition specified in section 1563(a), as modified in two respects: first, the threshold level of stock ownership is reduced from 80 percent to more than 50 percent; and second, the rules relating to component members under section 1563(b) are inapplicable (sec. 927(d)(4)).

come for purposes of the foreign tax credit limitation. If, however, a FSC earns nonexempt foreign trade income in a transaction using a pricing method described in section 482, the source and taxation of such income is determined under the present-law rules generally applicable to taxpayers other than FSCs.

b. Foreign tax credit

A FSC generally is not allowed a foreign tax credit or a deduction for foreign income, war profits, or excess profits taxes paid or accrued with respect to exempt or nonexempt foreign trade income (secs. 906(b)(5) and 275(a)(4)(B)). In addition, a shareholder of a FSC generally is not eligible for a foreign tax credit with respect to a foreign withholding tax imposed on a dividend attributable to foreign trade income (sec. 901(h)).

4. Foreign trading gross receipts

a. In general

In general, the term foreign trading gross receipts means the gross receipts of a FSC which are attributable to the export of certain goods and services. Foreign trading gross receipts generally are the gross receipts of any FSC that are attributable to the following types of transactions: the sale of export property; the lease or rental of export property; services related and subsidiary to the sale or lease of export property; engineering and architectural services; and export management services (sec. 924(a)).

For a FSC (other than a small FSC) to have foreign trading gross receipts, two additional sets of requirements must be met—the foreign management and foreign economic process requirements. A FSC will be treated as having foreign trading gross receipts only if the management of the corporation during the taxable year takes place outside the United States, and only if certain economic processes with respect to particular transactions take place outside the United States (sec. 924(b)).

b. Foreign management

The requirement that the FSC be managed outside the United States is treated as satisfied for a particular taxable year if (1) all meetings of the board of directors of the corporation and all meetings of the shareholders of the corporation are outside the United States; (2) the principal bank account of the corporation is maintained at all times during the taxable year in a U.S. possession or in a foreign country which is either a party to a CBI agreement with the United States, or an income tax treaty partner which the Treasury certifies as having a satisfactory exchange of information program under the treaty; and (3) all dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the corporation paid during the taxable year are disbursed out of bank accounts of the corporation outside the United States (sec. 924(c)).

c. Foreign economic processes

The foreign economic process requirements relate to the place where all or a portion of certain economic process activities are performed. The first requirement relates to the sales portion of the

transaction, and the second requirement relates to the direct costs incurred by the FSC.

Sales portion of the transaction.—A FSC is not considered to earn foreign trading gross receipts from a transaction unless the FSC, or a person under contract with the FSC, participates outside the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to the transaction (sec. 924(d)(1)(A)). The sales requirement generally is tested on a transaction-by-transaction basis.

Direct cost tests.—A FSC generally may not earn foreign trading gross receipts from a transaction unless the foreign direct costs incurred by the FSC attributable to the transaction are at least 50 percent of the total direct costs incurred by the FSC with respect to the transaction (sec. 924(d)(1)(B)).

The term "total direct costs" means, with respect to any transaction, the total direct costs incurred by the FSC at any location attributable to the activities relating to the disposition of export property (sec. 924(d)(3)(A)).[37] The term "foreign direct costs" means the portion of the total direct costs incurred by the FSC which are attributable to activities performed outside the United States (sec. 924(d)(3)(B)).

The requirement that the foreign direct costs incurred by the FSC be at least 50 percent of the total direct costs incurred by the FSC attributable to a transaction may be met by an alternative 85-percent test (sec. 924(d)(2)). Under this alternative test, a corporation is treated as satisfying the requirement that economic processes take place outside the United States if the foreign direct costs incurred by the FSC attributable to any two of the five categories of activities relating to disposition of the export property equal or exceed 85 percent of the total direct costs of those two categories.

d. Excluded receipts

Certain receipts are not included in the definition of foreign trading gross receipts. excluded from the definition of foreign trading gross receipts are receipts of a FSC from a transaction (1) if the export property or services are for ultimate use in the United States, or are for use by the United States and such use is required by law or regulation; (2) if the transaction is accomplished by a subsidy granted by the United States; or (3) in certain cases, if the receipts are from another FSC which is a member of the same controlled group (sec. 924(f)(1)). Investment income and carrying charges also are excluded from the definition of foreign trading gross receipts (sec. 924(f)(2)).[38] Income attributable to excluded receipts is not foreign trade income and, therefore, no portion of such income is exempt.

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[37] The five categories of activities that are considered in determining direct costs are (1) advertising and sales promotion, (2) processing customer orders and arranging for delivery, (3) transportation, (4) determination and transmittal of a final invoice or statement of account and receipt of payment, and (5) assumption of credit risk (sec. 924(e)).

[38] Investment income includes dividends, interest, annuities, royalties, rents other than from the lease of export property for use outside the United States, gains from the sale or exchange of stocks or securities, and certain other passive income (sec. 927(c)). Carrying charges include any amount in excess of the price for an immediate cash sale and any other unstated interest (sec. 927(d)(1)).

5. Transfer pricing rules

a. In general

If export property is sold to a FSC by a related person (or a commission is paid by a related principal to a FSC with respect to export property), the taxable income of the FSC and related person is computed based upon a transfer price determined under an arm's-length pricing approach or under one of two formulae ("administrative pricing rules") which are intended to approximate arm's-length pricing.

b. Conditions on use of administrative pricing rules

In order to use the special administrative pricing rules, a FSC must perform significant economic functions with respect to the sales transaction (sec. 925(c)). Accordingly, a FSC must meet two requirements. The first requirement is that all of the five activities (discussed above) with respect to which the direct costs are taken into account for the 50 or 85 percent foreign direct costs tests must be performed by the FSC or by another person acting under contract with the FSC. The second requirement is that all of the activities relating to the solicitation (other than advertising), negotiation, and making of the contract with respect to the sale must be performed by the FSC (or by another person acting under contract with the FSC).

c. Determination of transfer price

If the FSC buys export property from a related supplier and then resells to third parties, the rules permit the first transaction to be priced so as to allow the FSC to derive taxable income from the resale equal to the greatest of (1) 1.83 percent of the foreign trading gross receipts derived from the sale of the property; (2) 23 percent of the combined taxable income of the FSC and the related person from the resulting foreign trading gross receipts (these two pricing rules are the so-called "administrative pricing" rules); or (3) taxable income based upon the actual related-supplier-to-FSC sales price, but subject to the rules provided in section 482 (sec. 925(a)). Commissions, rents, and other types of income may be set under consistent principles (Treas. Reg. sec. 1.925(a)-1T).

The transfer pricing rules only apply to determine the price of a sale to a FSC (or FSC commissions). A FSC, or a principal for which the FSC is acting as commission agent, must sell to a related purchaser on an arm's-length basis, under the provisions of Code section 482, viewing the FSC and any related supplier as a single entity which sells to the purchaser.

d. Taxation of the FSC

As described above, a FSC is not subject to U.S. tax on exempt foreign trade income. A FSC's nonexempt foreign trade income is subject to U.S. tax unless it is determined without reference to an administrative pricing rule, in which case it will be taxed in the same manner and to the same extent as income earned by a foreign corporation that is not a FSC. Interest, dividends, royalties, other investment income and carrying charges are subject to U.S. tax (sec. 921(d)(2) and (3)).

6. Distributions to shareholders

A FSC is not required or deemed to make distributions to its shareholders. Actual distributions are treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits (sec. 926(a)). Any distribution made by a FSC which is made out of earnings and profits attributable to foreign trade income to a shareholder which is a foreign corporation or a nonresident alien individual is treated as a distribution which is effectively connected with the conduct of the trade or business conducted through a permanent establishment of the shareholder within the United States, and as U.S. source income (sec. 926(b)). Thus, such distributions will be subject to Federal income tax.

7. Dividends received from a FSC

A domestic corporation generally is allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income (sec. 245(c)(1)(A)). Thus, aside from possible alternative minimum tax consequences, there is no corporate level tax on exempt foreign trade income and only a single-level corporate tax (at the FSC level) on foreign trade income other than exempt foreign trade income. However, a 100 percent dividends-received deduction is not allowed for nonexempt foreign trade income determined without reference to an administrative pricing rule (sec. 245(c)(2)).

8. Other definitions and special rules

a. Export property

In general, the term export property means property manufactured, produced, grown or extracted in the United States by a person other than a FSC, held primarily for sale, lease, or rental in the ordinary course of trade or business for direct use or consumption outside the United States, and not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (sec. 927(a)). The term export property does not include (1) property leased or rented by a FSC for use by any member of a controlled group of which the FSC is a member, (2) patents and other intangibles, (3) oil or gas (or any primary product) thereof, or (4) products the export of which is prohibited. Export property also excludes property designated by the President as being in short supply.

b. Gross receipts

In general, the term gross receipts means the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of a trade or business, and gross income from all other sources (sec. 927(b)). In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of these provisions as gross receipts is the gross receipts on the sale, lease, or rental of the property on which the commissions arose.

c. Small FSC

A FSC that elects to be a small FSC need not meet the foreign management and foreign economic process requirements in order to have foreign trading gross receipts (sec. 924(b)(2)(A)). In determining the exempt foreign trade income of a small FSC, however, any foreign trading gross receipts that exceed $5 million are not taken into account (sec. 924(b)(2)(B)). The activities attributable to a sale and described in section 924(d) and (e) must still be performed by the FSC or by another person acting under contract with the FSC (sec. 925(c)). If the foreign trading gross receipts of a small FSC exceed the $5 million limitation, the corporation may select the gross receipts to which the limitation is allocated.

d. Shared FSCs

Special rules are provided for FSCs with multiple shareholders that meet certain specifications (generally referred to as shared FSCs). A shared FSC is any FSC that maintains a separate account for transactions with each shareholder, that bases distributions to each shareholder on the amounts in the respective shareholder's separate account, and satisfies any other requirement set forth in regulations (sec. 927(g)(3)).

In general, each separate account so maintained by a shared FSC is treated as a separate corporation for income tax purposes (sec. 927(g)(1)). Separate corporation status does not apply for certain corporate-level requirements for FSC status, for the foreign presence requirements, and for the determination of whether the FSC is a small FSC (sec. 927(g)(2)).

II. ANALYSIS OF ISSUES RELATING TO INTERNATIONAL INVESTMENT

A. Overview

International investment plays an important role in determining the total amount of worldwide income as well as the distribution of income across nations. In addition, international investment flows can substantially influence the distribution of capital and labor income within nations. Because each government levies taxes by its own method and at its own rates, the resulting system of international taxation can distort investment and contribute to reductions in worldwide economic welfare. A government's tax policies affect the distribution of income directly, by collecting tax from foreigners earning income within its borders and from residents earning income overseas, and indirectly by inducing capital movements across national borders.

As a whole, the U.S. system of taxation is a hybrid containing elements consistent with both capital import neutrality and capital export neutrality. With regard to the relative treatment of domestic and outbound investment, many provisions work at cross purposes. Some provisions of current law favor outbound investment, while others discourage it.

B. Departures From Capital Export Neutrality in Current U.S. Tax Rules

A government can implement capital export neutrality by taxing worldwide income of its residents but also allowing credits for taxes paid to foreign governments. Alternatively, a government can implement national neutrality by replacing credits with deductions for foreign taxes. Finally, a government can implement capital import neutrality by exempting all foreign source income from tax. Since national neutrality is less generous to taxpayers than capital export neutrality, deviations from capital export neutrality that increase tax on foreign income move the U.S. system closer to a system of national neutrality. Conversely, since capital import neutrality is often more generous to taxpayers than capital export neutrality, deviations from capital export neutrality that decrease tax on foreign income move the U.S. system closer to a system of capital import neutrality.

1. Deferral of tax on foreign income

Income from outbound investments earned by the separately incorporated foreign subsidiaries of U.S. corporations generally is not subject to tax until that income is repatriated. However, income from foreign branches of U.S. corporations must be included in current taxable income. The majority of foreign business activity controlled by U.S. corporations is conducted by separate foreign corporations as opposed to branches. In 1990, the largest 7,500 CFCs of U.S. multinationals had $102.6 billion of earnings and profits and paid $23.8 billion of foreign income taxes.[39] Foreign branches

[39] Internal Revenue Service, "Controlled Foreign Corporations," *Statistics of Income Bulletin*, pp. 89-111 (Summer 1994).

of U.S. multinationals had $57.6 billion of branch income and paid $4.0 billion of foreign income taxes.[40]

If for a particular taxpayer the effective rate of foreign tax can be expected to be consistently above the U.S. rate, deferral of U.S. taxes would not provide any tax benefit. However, if the effective rate of foreign tax is at any time or in any jurisdiction below the U.S. rate, U.S. multinationals may enjoy two substantial benefits from deferral. First, deferral may delay the payment of U.S. taxes on foreign source income until earnings are repatriated. Second, because excess foreign tax credits cannot be carried forward indefinitely, deferral expands the opportunity for cross-crediting (if effective foreign tax rates vary across years or across jurisdictions) by not deeming high foreign taxes to be paid until a year when the U.S. taxpayer chooses also to repatriate low-taxed foreign source income.[41] The benefit from the deferral of tax until foreign earnings are repatriated may be viewed as similar to the benefit enjoyed from delaying realizations of capital gains. As with capital gains, one method of eliminating the tax benefit of deferral is the payment of taxes on income as it is earned, rather than when payment is received. This is achieved, in limited circumstances, by the various anti-deferral regimes in the Code.

Deferral does, however, impose costs on taxpayers. For example, subpart F, and its interactions with the credit rules and the other anti-deferral rules, are considered highly complex.[42] In addition, the interest allocation rules, by precluding full worldwide fungibility of interest among commonly controlled domestic *and foreign* subsidiaries, may impose costs on a U.S. corporation that operates through foreign subsidiaries, which costs might be avoided by operating through foreign branches of a U.S. corporation.

To the extent that deferral continues to provide an advantage to outbound investment, this advantage provides an incentive for outbound investment and therefore moves the U.S. system of taxation of foreign income closer to capital import neutrality and away from capital export neutrality. Deferral provides an incentive for outbound investment, but restrictions on deferral negate this incentive.

2. Foreign tax credit limitation

For taxpayers in an excess foreign tax credit position (that is, taxpayers with creditable foreign taxes in excess of the foreign tax credit limitation), tightening limitations on the foreign tax credit may, when foreign laws are taken into account and are assumed not to change as a result of the tightening, result in discouraging outbound investment and encouraging domestic investment. In

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[40] Internal Revenue Service, "Corporate Foreign Tax Credit, 1990: An Industry Focus," *Statistics of Income Bulletin*, pp. 78-106 (Spring 1994).

[41] This second benefit is in some degree limited by the less generous foreign tax credit carryover periods (back 2 years and forward 5 years) as compared to the net operating loss carryover periods (back 3 years and forward 15 years). For example, when a U.S. source loss for a year in which foreign source income is earned renders the crediting of foreign tax paid or deemed paid in that year unnecessary, the effect of the foreign income and taxes is to convert a loss, usable over the next 15 years, into a credit carryforward, usable only over the next 5 years. Thus, while deferral makes it possible for the taxpayer to choose the year in which the tax will be deemed paid, the reduced carryforward period prevents the taxpayer from also enjoying the flexibility to use its excess credits over the full 15 years accorded to losses.

[42] E.g., Tillinghast, "International Tax Simplification," 8 *Am. J. Tax Policy* 187, 190 (1990).

order for a credit system of foreign taxation to be fully consistent with capital export neutrality where it is assumed that no changes in source country law are possible, unlimited credits for foreign tax payments against residence country tax liability would have to be available to taxpayers in their country of residence. This would include a grant by the residence country to the taxpayer of the amount, if any, by which such source country tax exceeds residence country tax. In other words, for a credit system of outbound taxation to be fully capital-export neutral, the residence country must be willing to relinquish tax jurisdiction over domestic income.

It is important to recognize that when the foreign tax credit limitation is binding, the disincentive to outbound investment results primarily from foreign effective rates of tax in excess of the domestic rate. The only "fault" of the foreign tax credit limitation in the context of capital export neutrality is that subsidies are not provided in the form of foreign tax credits in excess of domestic tax liability. The reduced availability of foreign tax credits may, however, be accompanied by reductions in effective foreign tax rates.

In 1921, three years after the foreign tax credit was first made available to U.S. taxpayers, the credit was limited to the amount of tax that would be paid at domestic rates on foreign source income computed under U.S. tax rules. Taxpayers in an "excess limit" position (that is, taxpayers with foreign tax credit limitation in excess of creditable taxes) have no incentive to reduce their foreign taxes, and foreign governments have no inducement to lower their income taxes on income earned by those U.S. taxpayers. Without the credit limitation, there would be no reasonable bound on the potential transfer of funds from the U.S. Treasury to foreign governments. To the extent of U.S. tax liability (before foreign tax credits), the level of foreign taxation would be a matter of indifference to the U.S. investor since increased foreign taxes effectively would be paid by the U.S. Treasury.[43] The foreign tax credit limitation is thus among the most important of a variety of revenue protection features of the U.S. system of international taxation. To the extent that U.S. tax rates fall relative to foreign tax rates, the importance of the foreign tax credit limitation increases.

3. Cross-crediting of foreign taxes

In its 1984 tax reform proposals, the Treasury Department proposed a per-country foreign tax credit limitation to replace the overall limitation which provided "many taxpayers a tax motivated incentive to invest abroad rather than in the United States."[44] This tax reform proposal addressed the use of high foreign taxes imposed by one country (i.e., taxes in excess of the U.S. rate) to offset U.S. tax on income earned by the same U.S. taxpayer in a low-tax country. This is sometimes referred to as "averaging" or "cross-crediting."

The creation of new separate foreign tax credit baskets in the final version of the 1986 Act reduced in a different way the ability on U.S. taxpayers to average foreign tax liability on highly taxed

[43] In this case, the only limitation would be that foreign tax credits cannot exceed U.S. tax liability.

[44] U.S. Treasury Department, *Tax Reform for Simplicity, Fairness, and Economic Growth*, Vol. 2, 1984, p. 361.

foreign income against the foreign tax liability on lightly taxed income. For example, the passive income basket included in the 1986 Act reduced the incentive for U.S. taxpayers with excess foreign tax credits to reallocate funds from domestic uses to portfolio investments in low-tax countries. With an ability to "cross-credit" between taxes on active and passive income, a corporate taxpayer paying, for example, 45-percent tax on $100 of active income from one country would be able to make investments yielding $100 in another jurisdiction with a tax rate as high as 25 percent on investment income, and be subject only to foreign tax. The taxpayer in this instance has a tax incentive to invest abroad since his marginal rate of tax is 25 percent on outbound investment compared to 35 percent on domestic investment. Separate basketing requires an additional 10 percent of U.S. tax to be paid on this outbound investment.

In terms of the principles discussed above, limiting the ability to cross-credit moves the tax treatment of the marginal outbound investment by a U.S. investor away from capital import neutrality and toward capital export neutrality. On the other hand, under current U.S. law, taxpayers may cross-credit high foreign taxes paid to one country against U.S. tax on similar types of income earned in other low-tax foreign countries. Complete elimination of cross-crediting may be undesirable for administrative reasons, quite apart from issues of capital import and export neutrality. For example, substantial administrative issues could arise in the allocation and apportionment of foreign income of an integrated multinational business among separate foreign countries in which operations take place. Some of the separate foreign tax credit limitation rules of current law already create what may be regarded as undue complexity.

4. Creditability of subnational foreign taxes

Under present law, taxes paid by U.S. businesses to foreign governments that are by their nature taxes on income or profits, such as a corporate income tax, are fully creditable (within the foreign tax credit limitation) against Federal income taxes. This applies whether the tax is imposed by the national government or by a subnational government of that foreign country. However, income taxes paid by U.S. businesses to the States or to other subnational governments within the United States are only deductible against Federal income tax. Depending upon the rates of U.S. and foreign national and subnational taxes, this disparity in treatment of subnational taxes can create an incentive to invest overseas. This is the case when the foreign tax credit limitation is not binding and the overall (i.e., national and subnational combined) level of foreign income tax is lower than the level of U.S. Federal and local income tax.

To illustrate this point, assume that an investor can earn $100 before both national and local taxes from either a domestic or outbound investment, and that the rate of U.S. Federal income tax is 35 percent and the foreign national rate is 20 percent. Before taking into account other, subnational taxes, the U.S. taxpayer would earn $65 after-tax from either domestic or outbound investment. In the case of outbound investment, the investor pays $20 of tax to

the foreign government and $15 (after foreign tax credits) to the U.S. government. Now assume that subnational governments in both the United States and the foreign jurisdiction impose a 10-percent income tax. On domestic investment, the investor pays $31.50 of Federal tax (0.35 times $90) and $10 of subnational income tax, resulting in an effective rate of tax of 41.5 percent and leaving the investor with $58.50 after tax. On outbound investment, the investor pays $18 of tax to the foreign national government and $10 to the foreign subnational government. Because the total foreign tax paid does not exceed the foreign tax credit limitation, all the foreign taxes are creditable. The taxpayer owes $7 to the U.S. government and is left with $65 after tax.

5. Export incentives

A fundamental decision facing any U.S. business is whether to locate some portion of production overseas. In the case of a business that sells products overseas, the investment location decision to invest abroad or domestically can be influenced by the availability of tax incentives for exports. Export subsidies, like tariffs that penalize imports, reduce global economic welfare. Furthermore, although they undoubtedly improve the lot of the favored export sector, they generally can be expected to reduce the overall economic welfare of the nation providing the subsidy. Nevertheless, tax and other export incentives may reduce the incentive of U.S. businesses to locate production abroad. One of the tax incentives providing favorable treatment to the taxation of income from exports is contained the provisions available to exporters who make use of foreign sales corporations (FSCs).

The predecessor of the FSC, the domestic international sales corporation (DISC), was first included in the Code in 1971. Under the DISC rules, corporations which derived no less than 95 percent of their receipts from qualified exports could indefinitely defer 50 percent of their income from U.S. tax. These provisions were said to be intended to improve the U.S. merchandise trade deficit by subsidizing exports. Furthermore, they were intended to promote investment in the United States by U.S. firms. In fact, they were intended to offset the incentive provided by deferral for U.S. firms to invest overseas.[45]

The European Economic Community argued that the DISC rules were not legal under the General Agreement on Trade and Tariffs (GATT), and in the early 1980s the GATT Council urged the United States to amend the DISC rules to conform to the GATT. Congress enacted the FSC rules in 1984 in order to resolve the GATT dispute over DISCs.[46] The FSC rules provide a domestic investment incentive for any U.S. taxpayer regardless of whether or not it pays foreign tax or is in an excess credit position.

[45] See *1972 Economic Report of the President*, pp. 167-168.

[46] For a more detailed description of DISC and GATT rules, see Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 1041-1042.

C. Tax Treaties

1. In general

Treaties involve trade-offs between the tax benefits they provide to inbound and outbound investments. Policy issues are implicated by the trade-offs. For example, treaties might be seen as benefiting U.S. outbound investment at the cost of reducing U.S. revenues from tax on inbound investment.[47] Treaties might be seen as benefiting the United States by increasing the inflow of investment at the cost of increasing investment outflows and reducing the U.S. tax take from the inflow. Or treaties might be seen as benefiting the United States simply by reducing barriers to the free flow of resources at the cost of reducing U.S. tax revenues. In each case, treaties raise the issue of whether their perceived benefits are in fact benefits, whether they are worth the costs, and whether more efficient approaches would be superior.

The discussion that follows will concentrate on the policy issues arising from the tax benefits achieved from applying treaty rules to outbound investment. It is worth remembering, however, that every such benefit is connected, to a greater or lesser degree, to benefits the residents of the other treaty country achieve vis-a-vis their own U.S. tax liabilities.

An overarching treaty issue regarding outbound investment is whether the reduction in foreign tax benefits the U.S. Treasury, U.S. taxpayers or the United States as a whole. For example, a U.S. taxpayer with excess foreign tax credit limitation generally will not benefit from a treaty reduction in foreign tax on income currently includable in U.S. taxable income. That is, U.S. tax liability will replace the reduced foreign tax liability. In this case, the treaty directly benefits the U.S. Treasury. A taxpayer with excess foreign tax credits would find that a treaty reduction in foreign tax is not offset by an equal increase in U.S. tax. Thus, the treaty directly benefits the taxpayer, not the Treasury.

The issue becomes whether this net tax savings of the U.S. taxpayer on its foreign income is also a net benefit to the United States. The conclusion reached becomes more significant to treaty policy the more U.S. taxpayers are likely to be in an excess credit position.

A related issue is the degree to which treaties are desirable from a U.S. policy perspective simply because foreign tax reductions of any amount are achieved, and the degree to which the amount of foreign tax reduction sought in negotiations should rightfully be measured by the degree to which they eliminate aspects of foreign laws that discriminate against foreign investors or foreign income of domestic investors. According to one commentator writing prior to the advent of the 1986 expense allocation changes, "*because other countries overtax foreign income,* the United States undertaxes domestic income."[48] Therefore, it can be argued that a legitimate role for treaties, namely, to encourage the reduction of

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[47] For a discussion of the impact of treaties on the taxation of inbound investments see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990, pp. 43-54.

[48] Charles Kingson, "The Coherence of International Taxation," 81 *Columbia Law Review* 1151, 1234 (1981) (hereafter cited as "Kingson").

disparately large foreign tax burdens of U.S. outbound investors vis-a-vis residents of the treaty country, became an especially timely one after the advent of those rules.

2. Tax sparing

One treaty issue particularly affecting the treatment of outbound investment concerns the U.S. negotiating position with respect to tax sparing. As explained in Part I.A.4.d., tax sparing would require the reduction or elimination of U.S. tax on income from activities in the source country, for example by allowing a credit for foreign taxes even though the taxes are not actually paid due to a tax holiday or other local tax incentive program. Tax sparing generally is sought by countries seeking, for their own policy reasons, to encourage inbound foreign investment through tax incentives.

Proponents of tax sparing have argued that U.S. multinationals are *prevented* by the absence of tax sparing from receiving the benefit of foreign tax incentives to investment in the foreign country. It is asserted, therefore, that if the United States spared the right to levy home country tax on foreign income, U.S.-based multinationals could tap low cost labor and raw material markets in developing countries at an after-tax cost "far below" that currently available to them. Thus, proponents of tax sparing argue that current U.S. policy not to enter into tax-sparing agreements hinders U.S. companies from access to the low cost labor and raw materials necessary to compete equally in world trade.[49]

Opponents of tax sparing argue that if the goal of tax sparing were to relieve U.S. tax burdens that might otherwise deter active foreign investment, then under present law, tax sparing is actually unnecessary, given the deferral permitted on active foreign income earned by a U.S. person through a foreign subsidiary. Industries that historically have not taken advantage of deferral—i.e., that have operated abroad in branch form—include natural resources industries which, it is argued, must base their operations where the resources are located, regardless of local tax incentives. It may also be argued that these industries paying sufficient amounts of foreign tax have found themselves to be exempt, in effect, from bearing any additional U.S. tax burden on that income.

It is further argued that tax sparing interacts with the foreign government's internal tax policy to the detriment of tax policy for all concerned. Given a certain level of government expenditures and a certain level of debt-financing of those expenditures, a country choosing to impose an income tax has a choice of imposing a relatively low income tax rate on a broad income base, or of imposing a higher rate accompanied by tax incentives. It has been argued that the latter type of system is inefficient because of its "uneven playing field." In many cases, the government concerned is also dependent on foreign loans or foreign aid to finance the shortfall in revenues caused by the allowance of inefficient tax incentives. Thus, allowance of tax concessions by countries seeking to further their economic development increases pressure on international financial markets and institutions, as well as on foreign aid budgets. It is argued that a treaty device which encourages

[49] Arthur Young & Co., *The Competitive Burden: Tax Treatment of U.S. Multinationals* (1988).

U.S. investors abroad to bring pressure on foreign countries to grant tax concessions interferes with the development of foreign tax systems.[50] It is further argued that because in return for United States agreement to provide tax sparing, the treaty country grants to U.S. residents reduced local taxes on payments such as interest, royalties, and dividends, the pressures on the treaty country government that are fostered by tax sparing are increased further by reduced local revenues.

A criticism of tax-sparing agreements negotiated in the past, in addition, is that the amount of credit is based on the amount of taxes saved under the treaty country's tax incentive system (a pure foreign law issue), rather than the amount of tax actually paid (a real economic cost to the taxpayer) or income earned in the foreign country (a U.S. law issue). The credit is based on a fictional amount to be determined by foreign tax administrators, thus, it is said, placing U.S. taxes at the risk of foreign tax administration.[51]

When the issue of tax sparing was considered by the Senate Foreign Relations Committee in 1957, Congress had recently considered and rejected proposals to reduce the U.S. tax rate on the foreign income of U.S. persons, thus making it particularly unsuitable, it was argued, to do so by treaty so shortly after the rejection.[52] In the 1970s and 1980s, the Treasury again proposed making creditable through treaties certain foreign taxes that were not creditable under the Code. According to the Senate Committee on Foreign Relations, the House Committee on Ways and Means and the Senate Committee on Finance made it clear that they did not think treaties were the appropriate vehicle for granting such credits.[53] It has also been argued that giving tax-sparing benefits with respect to one foreign country will greatly increase the pressure to do it for others.

3. Integration of corporate/shareholder taxation

U.S. treaty policy toward integration benefits for cross-border dividends seems to be based on a view that U.S. investors in corporations resident in countries with integrated corporate/shareholder taxation systems should receive source country tax reductions on their dividends from such corporations, and may fairly take a credit under U.S. law based on an amount of tax imposed by the foreign country not on the shareholders, but the corporations.

The treaty issue is not only *whether* the United States will seek foreign tax reductions for the benefit of U.S. investors in the treaty country, and will forgo some U.S. tax that might otherwise take the place (under U.S. statutory law) of the reduced foreign taxes; the issue also involves arriving at a view as to *what level* of foreign tax reduction is to be sought and what degree of U.S. tax reduction is believed tolerable. For example, between the time Germany enacted its imputation system (1977) and the time the 1989 treaty was signed, the Treasury Department expressed the view that the

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[50] *Double Taxation Convention with Pakistan: Hearing before the Senate Comm. on Foreign Relations,* 85th Cong., 1st Sess.1–32 (1954) (testimony of Professor Stanley Surrey) (hereinafter cites as *"Pakistan Treaty Hearing"*).

[51] *Pakistan Treaty Hearing* 7.

[52] *Pakistan Treaty Hearing* at 2, 26.

[53] Exec. Rep. No. 98-23, 98th Cong., 2d Sess. 12 (1984).

most appropriate adjustment to German tax on U.S. investment in German companies would be for Germany to grant U.S. shareholders refunds of the full 36-percent German federal corporate tax on distributed profits.[54]

As explained above in Part I.A.4., however, the treaty that was actually signed generally provides U.S. direct investors no imputation benefit, and provides U.S. portfolio investors in German resident companies with a 5-percent rate reduction relative to the generally applicable 15-percent source country treaty withholding rate for dividends paid by German resident companies. German shareholders, by contrast, receive a credit under internal German law for the full 36-percent "distribution burden" that German corporate earnings bear at the corporate level.

Under the treaty that was finally signed, then, U.S. investors in German resident companies receive the benefit of the German split-rate system, but receive a smaller imputation-related benefit than German shareholders in German resident companies receive for dividends paid by the companies.

Only under the U.K. treaty does the U.S. direct investor receive source country rate reductions to account for integration. The U.K. treaty does afford U.S. portfolio investors integration benefits analogous to those of domestic investors.

The issue is the degree of integration benefit that the United States will consider acceptable in its treaties. The outcome of the German treaty negotiation demonstrated that the United States was willing to accept less than full parity for its investors in Germany. Some may argue that this bargain falls short of what is acceptable. Others may argue that the benefits actually achieved in the German treaty constituted a reasonable compromise with German internal policy.

Moreover, it has been a well-established principle of international taxation that the country in which income-producing activity occurs is entitled to collect tax on the income from the activity. Therefore, any treaty system of dividend taxation would likely be designed to permit the source country to retain an adequate percentage of the tax that would have been imposed had the shareholder been domestic.[55]

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[54] Treasury Department News Release B-1703 (July 2, 1979).

[55] Cf. Kingson at 1241-3 (suggesting that as of 1981 the percentage of tax claimed by reason of source jurisdiction alone generally falls between 60 and 80 percent of the source-residence total, with a high of 95 percent under German internal law at the time, and a low of 25 percent by the United Kingdom under the U.S.-U.K. treaty).

III. COMPARISON OF TAXATION OF FOREIGN INCOME IN THE UNITED KINGDOM, GERMANY, AND JAPAN

This part provides for purposes of comparison a brief summary of the income tax treatment of foreign source income under the tax laws of the United Kingdom, Germany, and Japan. The summary is not intended as an authoritative representation of the laws of these countries. The staff of the Joint Committee on Taxation prepared this summary with the assistance of the staff of the Law Library of the Library of Congress.[56]

A. Treatment of Foreign Income in the United Kingdom

1. Foreign tax credit

The worldwide income and gains of U.K. resident individuals and corporations generally are subject to current U.K. tax.[57] In order to prevent an item of non-U.K. source income from being taxed by the source country and again by the United Kingdom, U.K. tax law provides a foreign tax credit (i.e., a credit against U.K. tax on that income to the extent of foreign taxes incurred on that income).

Certain limitations are placed on the ability of taxpayers to utilize foreign tax credits. The foreign tax credit is available only on a source-by-source (i.e., country-by-country) basis. Thus, excess foreign taxes attributable to one source generally may not offset the residual U.K. tax on untaxed or low-taxed foreign income from a different source. However, taxpayers are able to achieve some degree of averaging of foreign taxes through the use of so-called "mixing" corporations. Finally, there is no allowance for a carryback or carryforward of unused foreign tax credits. In cases where credits would go unused, taxpayers may elect to forego the foreign tax credit and instead claim a deduction for foreign taxes.

U.K. law also provides for an indirect foreign credit in the case of certain dividend income earned by a U.K. resident company. Where the dividend is from a non-resident company, the foreign tax credit applies to any tax directly withheld from the dividend, as well as to a portion of the foreign taxes incurred by the payor corporation with respect to the profits so distributed. In order to qualify for the indirect foreign tax credit, the U.K. company (or its parent company) must directly or indirectly own at least ten percent of the foreign company's voting stock.

2. Income earned through foreign subsidiaries

Income earned by non-U.K. subsidiaries (except to the extent they are connected to business operations in the United Kingdom) is not subject to U.K. tax until it is repatriated in the form of dividends. In 1984, special legislation covering controlled foreign companies was introduced. This legislation eliminated the deferral of

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[56] The text summarizes the laws of the United Kingdom and Japan as in effect on January 1, 1995, and of Germany as in effect in 1992.

[57] However, if the earnings of a foreign branch cannot be remitted to the United Kingdom as a result of foreign restrictions, deferral of payment of U.K. tax on that income is allowed.

U.K. tax on certain earnings of foreign subsidiaries.[58] It mainly applies to operations located in tax haven countries.

3. Incentives for outbound investment

Generally, the internal tax laws of the United Kingdom provide no tax incentives for outbound investment other than the allowance of deferral on certain earnings of foreign subsidiaries. However, in certain cases where foreign countries have provided "tax sparing" relief to encourage inbound investment, the United Kingdom has agreed in tax treaties with those countries to allow a credit against U.K. tax for the foreign tax so spared.

B. Treatment of Foreign Income in Germany

1. Foreign tax credit

Disregarding treaties, an unlimited taxpayer (i.e., a German resident) generally owes German tax on worldwide income. Foreign income of an active foreign corporation controlled by one or more German taxpayers generally is not taxed in Germany unless repatriated to Germany.

A taxpayer may obtain relief from double taxation of foreign income through a credit for foreign income taxes the taxpayer incurs. For this purpose, foreign income can be business income attributable to a foreign permanent establishment. By contrast to U.S. law, business income from sales of property is not classified as foreign on the basis of, for example, the place where title to the property passes to the buyer. Other types of income (e.g., income from investment or employment abroad) may also be treated as foreign source income. Alternatively, foreign income taxes may be deducted.

The credit is limited on a per-country basis—that is, there is no cross-crediting of high foreign taxes against German tax on income from another, lower-tax, country. On the other hand, there is no reduction of the limitation for one country by losses in another country. Thus, a loss in one country would not reduce the creditable portion of the taxes imposed by another country. A taxpayer can elect separately on a country-by-country basis whether to take the credit or the deduction. For a country and a year for which the credit is taken, foreign tax in excess of the foreign tax credit limitation cannot be carried forward or back or deducted.

German tax on dividends from a foreign corporation to a German resident corporation that owns 10 percent or more of the stock of the foreign corporation can be offset by a credit for foreign income tax paid by the foreign corporation. There is also available against German tax on a dividend from such a foreign corporation a credit for taxes paid by a second-tier foreign subsidiary where the second-tier subsidiary paid a dividend to the first-tier subsidiary in the same year as the dividend from the latter to the German resident. Indirect foreign tax credits below the second tier are not allowed.

[58] The loss of deferral is accomplished by the Inland Revenue Department's treatment of the relevant earnings of the controlled foreign corporation as having been deemed distributed to its U.K.-resident corporate shareholders, who are in turn subject to U.K. tax on the deemed distributions. Individual shareholders are not subject to this anti-deferral regime.

Dividends from a developing country, as defined under the Developing Countries Tax Act (*Entwicklungslaender-Steuerge-setz*, or "EntwlStG"), may be exempt from German tax via a deemed indirect foreign tax credit equal to the German tax which would be payable absent a foreign tax credit. Argentina, China, Greece, India, Mexico, Portugal, and Spain are some of the countries included in this category.

In lieu of the foreign tax credit, state tax ministries are authorized to forgive partly or completely the tax on foreign source income, or to determine the tax at a flat rate, assuming that the federal authorities approve and the adjustment is in the interest of Germany's national economy or the application of the regular rules raises substantial difficulties in a particular case.

Certain income from operation of German-registered, German-flag merchant ships in international transportation is taxed at half the statutory rate.

2. Treaty exemptions from German tax on foreign income

Under treaties, foreign source income may be exempt from German tax. Approximately 60 tax treaties are in force. These exemptions apply to business income of a foreign permanent establishment, and dividends received by a German corporation from a foreign corporation owned at least 10 or 25 percent by the German corporation. For example, under the U.S.-German income tax treaty, there is excluded from the German tax base of a German resident any item of U.S. source income that, according to the treaty, may be taxed in the United States. In the case of dividends, the exemption applies only to U.S. source dividends paid to a German company directly owning 10 percent or more of the voting shares of the payer. In general, the treaty also prevents the United States from taxing U.S. source interest and royalties paid to German residents.

Thus, assume for example that a German company owns all the stock of a U.S. corporation from which it receives dividends, interest, and royalties. The dividends are exempt from German tax (and carry no direct or indirect foreign tax credits onto the German company's German tax return). The royalties and interest, on the other hand, are taxable by Germany, and there are no U.S. withholding taxes to credit against the German tax. Thus, such U.S. source income may well bear a full 50 percent income tax in Germany. By contrast, were the parent a U.S. company and the subsidiary German, there might be no U.S. tax imposed on the dividends, interest, or royalties after application of the direct and indirect German tax credits carried by the dividend against the U.S. tax on these items of income.

C. Treatment of Foreign Income in Japan

1. General rule of deferral

Japanese taxpayers are subject to income tax on their worldwide incomes, including income derived by foreign branch operations that is not remitted to Japan. Japanese taxpayers generally are not subject to taxation in Japan on the earnings of foreign corporations in which they own interests until the profits are repatriated to

Japan (in the form of dividend or liquidating distributions, or upon sale of the interests). This general rule of deferral, however, does not apply to certain tax-haven subsidiaries.

Certain Japanese taxpayers are taxable currently on their pro rata shares of the undistributed profits of Japanese-controlled corporations established in designated tax havens. Japanese taxpayers subject to this treatment are those owning (directly, indirectly, or constructively) five percent[59] or more of the stock in a tax-haven subsidiary that is owned (directly, indirectly, or constructively) more than 50 percent by Japanese taxpayers. Japan's Ministry of Finance has designated 41 jurisdictions as tax havens. Tax-haven countries include any country where the effective rate of tax applicable to the Japanese-controlled corporation in question is "substantially low," which is defined in a Cabinet order as 25 percent or less. The effective rate of tax generally is computed under principles of Japanese law, and includes not only local taxes actually paid but also local taxes that are exempted or reduced to the extent that the exemption or reduction qualifies for a tax-sparing credit under the local country's tax treaty with Japan.

Actual distributions of previously taxed tax-haven profits are free of additional income tax if distributed within the next five years after the undistributed profits are taxed.

2. Foreign tax credit

Japanese corporations may credit certain foreign taxes against income taxes payable to Japan on foreign source income. Both direct and deemed-paid taxes are eligible for the credit, with 25-percent ownership in the foreign corporation generally required for deemed-paid credits. Deemed-paid credits are allowed for only first-tier and second-tier foreign corporations.[60] The ownership threshold is waived for purposes of deemed-paid credits with respect to certain shareholders in designated tax-haven subsidiaries. The ownership threshold also is reduced in certain tax treaties. For example, under the United States-Japan tax treaty, Japanese shareholders in U.S. corporations may take deemed-paid credits with as little as 10-percent ownership.

The foreign tax credit is subject to a limitation computed on an overall (as opposed to a per-country) basis. The limitation is computed on the basis of the national income tax only, although excess credits may be used, to a limited extent, against the corporation's local inhabitants income tax. Excess credits may be carried forward (but not back) for up to three years, and excess limitation may also be carried forward for up to three years (in effect, yielding a result similar to a carryback).

For purposes of determining the foreign tax credit limitation fraction, only one third of a taxpayer's foreign source income that is not subject to any foreign tax may be included in the numerator as foreign source income (although all of such income is included in the denominator as worldwide income), and the numerator (foreign source income) may not exceed 90 percent of the denominator (worldwide income). In addition, export sales from Japan are treat-

[59] Prior to the 1992 tax law amendments, this ownership threshold was 10 percent.

[60] Deemed-paid credits for second-tier foreign corporations have been allowed only since Japan's 1992 tax amendments.

ed as foreign source income only if they are sold through a fixed place of business in a foreign country, or if the income from the export sales is subject to tax in a foreign jurisdiction.

3. Tax sparing

Japan has entered into a number of tax treaties that provide "tax sparing" benefits with respect to tax holidays or other incentives granted by developing countries to foreign investors. Under tax sparing, Japanese investors in business operations in the other treaty country may take foreign tax credits against their Japanese tax liability as if they had actually paid the foreign taxes that were "spared" pursuant to the tax holidays. Japan currently offers tax sparing in its treaties with Bangladesh, Brazil, Bulgaria, China, India, Indonesia, Ireland, Korea, Malaysia, Pakistan, the Philippines, Singapore, Spain, Sri Lanka, Thailand, and Zambia.

IV. REVENUE ESTIMATING METHODOLOGY

A. Calculating a Baseline

Revenue estimates measure the anticipated changes in Federal receipts that result from proposed legislative changes to the Internal Revenue Code. The reference point for a revenue estimate is the revenue baseline, prepared by the Congressional Budget Office ("CBO"), which projects Federal receipts assuming that present law remains unchanged. Thus, in its simplest form, a revenue estimate measures projected Federal receipts under a proposed change in law minus the projected Federal receipts under present law. If this formula yields a negative result, the proposal is a revenue loser. If the formula yields a positive result, the proposal is a revenue raiser. The revenue baseline is based upon CBO forecasts of macroeconomic variables such as the annual rate of growth of nominal gross domestic product, inflation rates, and interest rates.

B. Behavioral Changes

Taxpayers are assumed to respond to proposals in ways that maximize their economic welfare and are consistent with the CBO macroeconomic assumptions. These responses include restructuring, comparing alternative tax treatments in the Code, and altering the timing of economic activities. U.S.-based multinational businesses compete with each other, with firms headquartered in other countries, and with entities that operate solely in the United States. The reactions of all parties, including other governments, are considered in the preparation of estimates of proposals to change the U.S. taxation of foreign source income.

Proposals to change the deferral of taxation of foreign-source income may cause a variety of responses. Taxpayers may change the form in which they conduct overseas activity, for example changing from a CFC to a partnership, or may shift financial assets in an attempt to benefit from a proposal. With regard to the tax treatment of income generated selling exports made in the United States, or goods and services produced overseas, the staff of the Joint Committee on Taxation ("Joint Committee staff") accounts for the possible tax treatment of such income under the Code. For example, it is assumed that there is a significant interaction between the provisions governing the sourcing of sales income and FSCs, such that a tightening or loosening of one is likely to change usage of the other.

C. Section 956A

The creation of Code section 956A in the 1993 Act offers an example of the application of the revenue estimating methodology employed by the Joint Committee staff.

Section 956A has the potential to cause adverse tax consequences for many multinational companies owning hundreds of billions of dollars worth of assets located overseas. A static estimate of this proposal would have shown large increases in budget receipts, perhaps hundreds of millions of dollars annually, attributable to the proposal's restriction of deferral of taxation of foreign source income. In contrast to this static approach, the actual estimate in-

cluded assumptions of significant behavioral response by taxpayers. This response included the purchase of assets affecting eligibility for deferral, and minor movement away from the CFC as an entity for conducting economic activity overseas. These considerations caused Joint Committee staff to estimate, during consideration of the 1993 Act, that section 956A would increase Federal budget receipts by less than $100 million annually.

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